103

# REGISTERED HOLDING COMPANY TRANSACTIONS



## HEARING

BEFORE THE

SUBCOMMITTEE ON
ENERGY AND POWER

OF THE

COMMITTEE ON
ENERGY AND COMMERCE
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

ON

THE 1992 OHIO POWER DECISION

MAY 26, 1994

**Serial No. 103–141**

Printed for the use of the Committee on Energy and Commerce



U.S. GOVERNMENT PRINTING OFFICE

84-385CC WASHINGTON : 1994

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-046169-3

8]

# REGISTERED HOLDING COMPANY TRANSACTIONS



## HEARING

BEFORE THE

SUBCOMMITTEE ON
ENERGY AND POWER

OF THE

COMMITTEE ON
ENERGY AND COMMERCE
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

ON

THE 1992 OHIO POWER DECISION

MAY 26, 1994

**Serial No. 103-141**

Printed for the use of the Committee on Energy and Commerce



U.S. GOVERNMENT PRINTING OFFICE
84-385CC WASHINGTON : 1994

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-046169-3

## COMMITTEE ON ENERGY AND COMMERCE

JOHN D. DINGELL, Michigan, *Chairman*

HENRY A. WAXMAN, California
PHILIP R. SHARP, Indiana
EDWARD J. MARKEY, Massachusetts
AL SWIFT, Washington
CARDISS COLLINS, Illinois
MIKE SYNAR, Oklahoma
W.J. "BILLY" TAUZIN, Louisiana
RON WYDEN, Oregon
RALPH M. HALL, Texas
BILL RICHARDSON, New Mexico
JIM SLATTERY, Kansas
JOHN BRYANT, Texas
RICK BOUCHER, Virginia
JIM COOPER, Tennessee
J. ROY ROWLAND, Georgia
THOMAS J. MANTON, New York
EDOLPHUS TOWNS, New York
GERRY E. STUDDS, Massachusetts
RICHARD H. LEHMAN, California
FRANK PALLONE, Jr., New Jersey
CRAIG A. WASHINGTON, Texas
LYNN SCHENK, California
SHERROD BROWN, Ohio
MIKE KREIDLER, Washington
MARJORIE MARGOLIES-MEZVINSKY, Pennsylvania
BLANCHE M. LAMBERT, Arkansas

CARLOS J. MOORHEAD, California
THOMAS J. BLILEY, Jr., Virginia
JACK FIELDS, Texas
MICHAEL G. OXLEY, Ohio
MICHAEL BILIRAKIS, Florida
DAN SCHAEFER, Colorado
JOE BARTON, Texas
ALEX McMILLAN, North Carolina
J. DENNIS HASTERT, Illinois
FRED UPTON, Michigan
CLIFF STEARNS, Florida
BILL PAXON, New York
PAUL E. GILLMOR, Ohio
SCOTT KLUG, Wisconsin
GARY A. FRANKS, Connecticut
JAMES C. GREENWOOD, Pennsylvania
MICHAEL D. CRAPO, Idaho

Alan J. Roth, *Staff Director and Chief Counsel*
Dennis B. Fitzgibbons, *Deputy Staff Director*
Margaret A. Durbin, *Minority Chief Counsel and Staff Director*

---

## Subcommittee on Energy and Power

PHILIP R. SHARP, Indiana, *Chairman*

EDWARD J. MARKEY, Massachusetts
RICHARD H. LEHMAN, California
CRAIG A. WASHINGTON, Texas
MIKE KREIDLER, Washington
BLANCHE M. LAMBERT, Arkansas
AL SWIFT, Washington
MIKE SYNAR, Oklahoma
W.J. "BILLY" TAUZIN, Louisiana
RALPH M. HALL, Texas
RICK BOUCHER, Virginia
JIM COOPER, Tennessee
JOHN D. DINGELL, Michigan (Ex Officio)

MICHAEL BILIRAKIS, Florida
J. DENNIS HASTERT, Illinois
CLIFF STEARNS, Florida
PAUL E. GILLMOR, Ohio
SCOTT KLUG, Wisconsin
GARY A. FRANKS, Connecticut
MICHAEL D. CRAPO, Idaho
CARLOS J. MOORHEAD, California (Ex Officio)

Shelley N. Fidler, *Staff Director*
Sue D. Sheridan, *Counsel*
Alvie Leon Lowery, *Special Assistant*
Karen K. Hunsicker, *Minority Counsel*

# CONTENTS

# REGISTERED HOLDING COMPANY TRANSACTIONS

---

**THURSDAY, MAY 26, 1994**

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE,
SUBCOMMITTEE ON ENERGY AND POWER,
*Washington, DC.*

The subcommittee met, pursuant to notice, at 9:37 a.m., in room 2322, Rayburn House Office Building, Hon. Philip R. Sharp (chairman) presiding.

Mr. SHARP. The subcommittee will please come to order. Today's hearing addresses the fundamental issue of consumer protection and the ability of the Federal regulators to oversee electricity rates.

In 1992, a Federal court ruled that the Federal Energy Regulatory Commission could not review the reasonableness of costs paid by one subsidiary of a registered holding company from coal purchased from another subsidiary of the same company. Despite the fact that FERC found these costs to be as much as the 94 percent higher than prevailing market prices, the court held that the full costs of the coal must be passed on to the consumers.

The case arose from a 1982 FERC ruling that disapproved the Ohio Power Company's request for approval under the Federal Power Act of a rate reflecting these above market costs. As it has done in other cases, FERC found that Ohio Power should not be allowed to recover a higher price for coal purchased from an affiliate than it would have paid to a non-affiliate seller.

The Ohio Power Company challenged FERC's order arguing that a prior ruling by the Securities and Exchange Commission preempted FERC from reviewing the reasonableness of these costs. Section 13(b) of PUHCA, the Public Utility Holding Company Act, which requires registered holding companies to obtain prior SEC approval of such interaffiliate agreements, is intended to bar sweetheart deals. In a novel argument, Ohio Power Company argued that the SEC's 1971 approval of its coal purchase agreement should preclude further FERC review on the grounds that the agency's actions otherwise would conflict.

While the D.C. Court of Appeals agreed with Ohio Power, the U.S. Supreme Court did not. The Supreme Court reversed the lower court's finding, holding that there was no conflict between the SEC's duty to review costs paid between affiliates and FERC's duty to determine which costs a utility may properly recover from its ratepayers. Justices Marshall and Stevens noted that to read PUHCA as displacing FERC's role under the Federal Power Act

made no sense and "would create a gap in the regulatory scheme that Congress could not have intended."

Following a series of judicial twists and turns, however, Ohio Power prevailed on a technical interpretation of FERC's implementing regulations. While FERC can remedy this problem administratively, I remain worried by the fact that in its final decision, the Court of Appeals took the highly unusual tack of squarely repudiating the Supreme Court's finding that there is no conflict between the SEC's and FERC's roles.

I believe that both agencies fulfill important and distinct responsibilities—the SEC primarily looking to protect investor interests, and the FERC watching out for electricity consumers' interests. On the one hand, it is wholly appropriate for the SEC to approve costs before a contract goes into effect. Such prior approval is the heart and soul of PUHCA's regulatory scheme for overseeing registered holding companies' financial activities.

On the other hand, it is wholly appropriate for FERC to conduct prudence reviews of the costs utilities incurred over time. I understand that, as the Ohio Power debate has progressed, some have argued that prudence review is inappropriate when it would upset a utility's profit expectations under an SEC-approved contract.

Ladies and gentlemen, prudence review is not an exceptional tool in energy regulation. In fact, it is the usual means by which FERC fulfills its responsibility to protect energy consumers. Participants in this debate must remember that electric utilities are regulated monopolies with State-protected service territories. This clearly distinguishes them from other businesses which do not enjoy the privilege of or face the economic temptations associated with a captive customer base.

Thus, regulatory review of a utility's past behavior is part and parcel of the traditional, long-standing regulatory compact between utilities and consumers.

I believe the legacy of the Ohio Power case is very unclear and promises nothing but trouble for all concerned, including the affected utilities, Federal agencies, State regulators and most of all, consumers. I would like to point out that more than 20 years passed between the time Ohio Power Company entered into the contract to purchase coal from its affiliate and the date of the final court decision. This, of course, is not a good model for energy regulation.

I believe Congress should resolve the ambiguities flowing from the Ohio Power case so that utilities can plan their affairs and all consumers will be assured of regulatory protection. There is no transaction more relevant to the purposes of both PUHCA and the Federal Power Act and none more deserving of FERC's scrutiny than an interaffiliate contract.

Further, consumers of registered holding companies certainly are no less deserving of thorough rate review than customers served by other utilities.

For these reasons, I want to commend our colleague, Rick Boucher, for his leadership in working on a bill to ensure that all consumers receive the protection Congress surely intended to confer when it enacted PUHCA and the Federal Power Act. I look forward to working with my colleagues to enact such legislation.

The Chair now recognizes the distinguished gentleman from California, Mr. Moorhead, the ranking member of the full committee.

Mr. MOORHEAD. Thank you, Mr. Chairman. I want to commend you for holding this timely hearing regarding the effect of the Ohio Power decision on the regulation of registered holding companies.

Some of our witnesses here today will tell us that the Ohio Power decision leaves a gap in our regulatory system through which electricity consumers may fall. Although no one disagrees that our regulatory system must ensure that consumers pay only just and reasonable prices for electricity, there has been much debate over the best mechanism for reaching that result.

The solution to this problem, whether legislative or regulatory, should result in consumers and investors protection, with a minimum of regulatory conflict.

This hearing provides the much needed forum for evaluating all of the different suggestions regarding the appropriate response to the court's decision in Ohio Power.

I look forward to hearing the views of the witnesses on the current state of the law as well as any recommendations they have for improving the regulation of this important and rapidly changing industry.

Thank you, Mr. Chairman.

Mr. SHARP. I thank the gentleman.

The Chair now recognizes the gentleman from Virginia, Mr. Boucher.

Mr. BOUCHER. Thank you very much, Mr. Chairman.

I appreciate your holding today's hearing on this very timely subject. The Ohio Power decision raises questions with large implications for the consumers of electric power marketed by the registered public utilities.

In effect, the decision allows the registered holding companies to pass along to their customers in electricity rates the cost of transactions among affiliated entities within the holding company structure without reference to the market value of the good or service that is transferred.

In the Ohio Power case, one AEP affiliate purchased coal from another affiliate of that holding company at a price which reflected the coal subsidiary's cost, but which amount was substantially above the price at which the coal could have been purchased on the open market. That higher cost based amount was passed along to the utility's customers.

The result of the litigation process that followed that transaction was that the pass-through was permitted since the Securities and Exchange Commission, which applies a cost test to such transactions, was found to have exclusive jurisdiction over the exchange.

The Federal Energy Regulatory Commission was found to be without authority to apply its test, which is based on the comparable market value of the product or the service that is transferred.

In my view, a legislative remedy to that decision is required in order to assure that consumers of electric power are not overcharged when costs above the prevailing market prices are passed along to them. At the same time, we should assure that in correct-

ing the problem, we do not create an imbalance in the regulation of registered companies on the one hand and exempt companies on the other.

We should be sensitive to the argument of the registered companies that led to the Ohio Power litigation in the first instance, that they were restricted to the lower cost, which is the test applied by the SEC, or the comparable market price, the test that is applied by the Federal Energy Regulatory Commission.

At a time when the exempts are not subject to SEC jurisdiction and therefore are allowed to recover the comparable market price, whether that price is above or below their cost, a legislative solution is needed.

But in drafting that solution, I would suggest that we need to address the question that just was raised, as well as questions concerning the application of a new law to existing contracts and investments and whether the new law will apply to goods only or to services as well, and whether some sort of preclearance is appropriate so that utilities will know the amount that can be recovered prior to their making investments or entering into contracts.

These are all difficult questions. They will require an extensive amount of consideration. I hope that our witnesses this morning will offer their views and opinions with regard to some of these matters, if not all of them, and I very much join with you, Mr. Chairman, in welcoming their attendance today, and I will look forward to working with you and your staff and Chairman Markey of the Telecommunications and Finance Subcommittee and his staff which shares jurisdiction with regard to this matter as we craft a legislative solution that meets the needs of consumers, and also does not impose unfair burdens on the registered utilities.

Thank you very much, Mr. Chairman.

Mr. SHARP. Thank you.

The Chair now recognizes the distinguished gentleman from Ohio, Mr. Gillmor.

Mr. GILLMOR. Thank you, Mr. Chairman, and thank you for holding this hearing.

The question before us is how many Federal agencies does it take to make sure that turning on a light bulb doesn't cost too much, and in my view, two is too many and one is not enough.

Unlike the court in the Ohio Power case, we do not start with the plain language of the statute and what Congress intended. We are free to disregard earlier decisions and put new ones in place. We start directly with the problems to be addressed, which in this case are protection of consumers from unreasonable rates and a protection of investors from sharp practices.

Both of these problems ought to be addressed, and I think that every one of our panelists would agree. Today is not the time to expand our perspective, but before considering any legislative action, we may need to get a sense of how the world has changed since 1935 and the extent to which our assumptions are still valid. Today we need only to determine whether the current system, in light of the Ohio Power case, is doing the job, and move on to discussing possible remedies if it isn't.

It appears that more oversight is needed than is provided for in the wake of the Ohio Power decision, but it does not seem nec-

essary to impose duplicative review of the same questions, and there are some alternatives we should look into, short of double review, that would serve our aims.

The name of the case may be Ohio Power, but this is by no means an Ohio problem we are considering. About 30 percent of the investor-owned utility market is covered by registered holding companies so consumers and investors across the country could be affected.

I do take a special interest in the matter though because of the priority it has obtained within the State of Ohio with Ohio residential and industrial consumers and with the Ohio registered utility which is involved in the case.

I look forward to the testimony today and to working with you, Mr. Chairman, and with those who have expressed particular interest in this problem, particularly Mr. Boucher.

Thank you, Mr. Chairman.

Mr. SHARP. I thank the gentleman.

The gentleman from Massachusetts, Mr. Markey is recognized.

Mr. MARKEY. Thank you, Mr. Chairman, and thank you very much for conducting today's hearing to review the implications of the Ohio Power decision for the ability of Federal and State regulators to review the reasonableness of costs charged to consumers in transactions between affiliates of registered holding companies. This is an important and complex issue which has very significant implications for utility ratepayers.

In 1935, Congress simultaneously enacted the Public Utility Holding Company Act and the Federal Power Act in response to the myriad of abuses to utility ratepayers and investors that occurred in the 1920's. The SEC was assigned the primary mission of protecting utility shareholders from pyramiding holding company structures, self-dealing transactions that benefitted utility officers and directors at the expense of shareholders and fraudulent and deceptive financial reporting.

The FERC and its predecessor agency was, among its other roles, assigned the primary Federal role in protecting captive utility ratepayers from having to foot the bill for excessive charges resulting from interaffiliate transactions. The States in turn retained authorities to develop and enforce integrated resource planning regulations.

The Ohio Power case has enormous potential consequences for a host of regulatory issues, including enforcement of PUHCA and State integrated resource planning regulations. It is ironic, to say the least, that many of the same utility companies that are quick to argue that there is no need for legislation to clarify PUHCA's regulatory regime following the Ohio Power case are the same companies, the very same companies, that are pushing this subcommittee, as well as my own, for dramatic changes in PUHCA's regulation of utility investments in telecommunications activities.

Furthermore, there is an additional important PUHCA related issue that was brought to our attention at the end of the long debate on the Energy Policy Act of 1992, and that is PUHCA's treatment of demand side investments outside of utilities' own customer service areas. Unfortunately, the reforms that we passed in 1992 that allowed registered holding companies to invest in supply side

projects throughout the United States and the world do not allow the same opportunities for investments in demand side activities by the registereds.

If this subcommittee does have another debate on PUHCA related issues this Congress, as we did in the last one, I am certain that we will need to discuss a broad range of issues to insure that investors and consumers are protected properly.

I want to commend Chairman Sharp for his leadership in insuring that this issue is given the proper spotlight which it deserves. The decisions which we make relating to these issues are historic in nature and I congratulate the Chair, and I yield back the balance of my time.

Mr. SHARP. The Chair thanks the gentleman.

Mr. MOORHEAD. Mr. Chairman, I ask unanimous consent that Mr. Bilirakis' opening statement be put in the record.

Mr. SHARP. Certainly, without objection, it will be.

[The opening statement of Mr. Bilirakis follows:]

STATEMENT OF HON. MICHAEL BILIRAKIS

Mr. Chairman, I am pleased that we are here today to investigate the status of registered holding company regulation in the aftermath of the Ohio Power decision. This is a very complicated issue, and one that I believe merits careful review before decisions are made regarding what legislative action, if any, should be taken.

There is no question that consumers should be protected from having to pay unjust and unreasonable rates for electricity. This was, and continues to be, the principal goal of the Federal Power Act. However, protection of the financial integrity of registered holding companies, the principal goal of PUHCA, is also very important. The question before us today is how to reconcile those two goals in a way that is fair to all concerned.

It is interesting to me that we are debating this, and other PUHCA issues, so soon after the passage of the Energy Policy Act PUHCA reform provisions. It is certainly true that the provisions of that act, along with existing market forces, are causing changes in the industry at a speed which few, if any, had predicted. As we consider the future structure of utility regulation, we must be aware of these changes and strive to form a coherent and workable regulatory structure that will facilitate, rather than hinder, competition.

I am eager to hear the opinions of our witnesses on how affiliate transactions should be regulated, as well as their views on the role of SEC and FERC regulation in light of increasingly competitive wholesale and retail electricity markets.

Mr. SHARP. The Chair now recognizes our first panel of witnesses. We are very pleased to have with us the Honorable Elizabeth Moler, the Chairman of the Federal Energy Regulatory Commission and the Honorable Richard Y. Roberts, a Commissioner with the Securities and Exchange Commission.

You are both quite familiar with our processes. We will certainly make your written materials a part of our record and appreciate hearing your oral summary at this point.

Ms. Moler

**STATEMENTS OF HON. ELIZABETH ANNE MOLER, CHAIRMAN, FEDERAL ENERGY REGULATORY COMMISSION; AND RICHARD Y. ROBERTS, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION, ACCOMPANIED BY WILLIAM C. WEEDEN, ASSOCIATE DIRECTOR, INVESTMENT MANAGEMENT**

Ms. MOLER. Thank you, Mr. Chairman, and members of the subcommittee. I am pleased to be here this morning to discuss the Ohio Power decision. This is not a trivial issue.

As a result of the Supreme Court decision and the D.C. circuit's decision, there is no effective mechanism in place today to fully protect 49 million households from excessive electricity rates. The Federal Energy Regulatory Commission now has no authority to review the costs of goods and services that utilities belonging to registered holding companies can generate by self-dealing.

I want to urge the committee to act favorably on legislation that will restore the FERC's ability to effectively regulate the rates of utilities that belong to registered holding companies.

There is no effective administrative remedy to this problem. Historically, as you have all observed, when a public utility member of a registered holding company entered into an affiliate contract for goods and services, that contract was reviewed by the SEC under the Public Utility Holding Company Act and the FERC or its predecessor, the FPC, under the Federal Power Act.

Before Ohio Power, both commissions would review the same intercorporate transactions. However, they reviewed them from different perspectives.

The SEC would review the transactions to protect corporate structure and investors, and the FERC to protect ratepayers and consumers. This all changed with the Ohio Power decision.

The court's decision and the events leading up to it are described in my written statement for the hearing record and have been amply described already this morning.

The effect of the court decision is significant. The SEC's review under the Holding Company Act cannot provide the same measure of rate protection that consumers have enjoyed since 1935.

If the SEC approves a contract under which the utility agrees to pay for goods or services at the cost of its associate company, then the FERC must allow these costs to be passed through, even if the goods or services are available elsewhere at a lower cost.

The SEC simply does not have the expertise or the regulatory procedures or statutory authority to provide the kind of rate protection that the FERC does. The SEC has never, to my knowledge, provided the regulatory test that ratepayers and consumers are entitled to under the Federal Power Act to insure that costs are not excessive and rates are not unjust or unreasonable.

Further, the SEC, acting under the Holding Company Act, lacks the consumer protection authority, including the refund authority, vested in the FERC to protect against excessive rates.

The impact of the Ohio Power decision is serious. There are nine electric registered utility holding companies. They serve directly or indirectly approximately 49 million households in 30 States. Their utility members provide about 25 percent of all power sold in the United States.

It is important to remember that there is room for abuse in intercorporate transactions. They are simply not arm's length competitive transactions. They are between affiliates and warrant regulatory review.

Let me describe a case that illustrates the effect of the Ohio Power decision and why we are hamstrung unless new legislation is enacted. In 1975, the FPC began an investigation into purchases of coal by AEP's affiliate companies.

Ratepayers may have paid, according to the testimony in the case, about $42 million in excess of market prices for this coal. The case eventually settled with $21 million being refunded to ratepayers and a cap put on the price of the affiliate coal.

If that case were brought today under Ohio Power, we would have to dismiss the complaint and ratepayers would be $21 million poorer. Indeed, since Ohio Power was decided, we have dismissed several cases on this same point.

The logic of Ohio Power is not restricted to fuel costs, although fuel is a significant cost of power. As a result of the court's decision, significant intercompany transactions, including contracts to build power plants and transmission lines and contracts to provide telecommunications and other services, could now be reviewed only by the SEC. The SEC will be responsible for potentially billions of dollars to be recovered from ratepayers.

Further, this problem is not restricted to wholesale transactions regulated by FERC. Although the Ohio Power decision did not specifically address State authority, it is arguable that the decision calls into question the authority of State public utility commissions to protect retail consumers from the results of intercompany transactions. You will hear more about that later from the second panel.

I would also support legislation that addresses any problems for States arising under Ohio Power. If the subcommittee considers legislation to remedy the problems created by the Ohio Power decision, there are five fundamental issues to consider.

First, the legislation to restore FERC authority would not create new burdensome regulation. This is not an efficiency question, as the registered holding companies are arguing in their testimony later today. Dual regulation has long been a fact of life for registered holding companies that have public utility subsidiaries.

Dual regulation is not duplicative regulation when different agencies regulate for different purposes and under wholly different statutory standards. If dual regulation is not restored over these transactions so that FERC can properly regulate, there will be an incentive for holding companies to form their corporate transactions to insulate major costs from rate review.

Second, the Federal Power Act already contains a specific section addressing conflicts between SEC and FERC jurisdiction. The Federal Power Act should be amended to restore the FERC authority. There is no need to open up the Holding Company Act to restore FERC jurisdiction.

Thus, if there is eventually going to be a broad scale review of the Public Utility Holding Company Act, it would not be inappropriate to act now to remedy this single aspect of the Ohio Power decision.

Third, it may be appropriate to clarify State authority to insure that rates have jurisdiction to review appropriate costs and retail rates. The National Association of Regulatory Utility Commissioners has taken a position on this legislation and you will hear testimony later today on this problem.

Fourth, any grandfathering of past transactions should be written narrowly to address only the fuel-related costs addressed in the Ohio Power case.

Fifth, if legislation is enacted to restore FERC's authority, the FERC and the SEC will attempt to develop consistent policies in order to provide registered holding companies greater regulatory certainty. Our staffs have in recent years been attempting to work together and to coordinate more closely.

From FERC's perspective, this has been beneficial, and let me assure you, it will continue. But administrative action alone simply is not enough. We need a statutory change.

I urge the Congress to restore the regulatory balance that we, the Federal Energy Regulatory Commission, the Securities and Exchange Commission, State regulators, investors and ratepayers knew for over 50 years. Ratepayer protection demands no less.

Thank you.

Mr. SHARP. Thank you very much.

[Testimony resumes on p. 33.]

[The prepared statement of Ms. Moler and responses to subcommittee questions follow:]

**Testimony of**
**Elizabeth Anne Moler, Chair**
**Federal Energy Regulatory Commission**

**Before the**
**Subcommittee on Energy and Power**
**Committee on Energy and Commerce**
**U.S. House of Representatives**
**May 26, 1994**

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here this morning to discuss the policy issues presented by the 1992 Ohio Power decision by the United States Court of Appeals for the District of Columbia Circuit. That decision severely impairs the ability of the Federal Energy Regulatory Commission (FERC) to effectively regulate the rates of entities that are public utilities under the Federal Power Act (FPA) and that are also members of registered public utility holding company systems under the Public Utility Holding Company Act (PUHCA).

The Commission no longer has the authority to review the costs incurred when these public utilities purchase goods, services or construction work from their affiliates. Review of affiliate contracts now resides solely in the Securities and Exchange Commission (SEC). The SEC's exclusive review authority means that FERC is unable to protect ratepayers from the effects of imprudent or abusive affiliate transactions.

This means that electricity consumers served by registered holding company systems will be treated differently than

consumers that are not served by registered systems. Major components of their rates may now be insulated from the rate review that had been in place from 1935 until the court's decision.

I urge the Committee to consider amendments to the FPA that would restore the FERC's ability to regulate the rates of public utility members of registered holding companies in the same way it regulates the rates of all other public utilities.

In assessing the need for such legislation, it is important to understand the existing overlap in jurisdiction of the SEC and the FERC, the recent court decisions affecting the agencies' respective jurisdictions, and the specific impacts of those court decisions on the rates of electric utilities.

Existing Statutory Framework: SEC/FERC Jurisdiction

Under the existing statutory framework, there is overlap in the jurisdiction of the SEC and the FERC. The SEC has jurisdiction over public utility holding companies under PUHCA. The FERC has jurisdiction over public utilities under the FPA. The two statutes contain specific definitions of "public-utility company," "holding company" and "public utility." A public utility "holding company" under PUHCA includes, in part, any company that directly or indirectly owns, controls or holds the power to vote 10 per centum or more of the outstanding voting

securities of any company that owns or operates facilities used for the generation, transmission or distribution of electric energy for sale. A "public utility" under the FPA means any person who owns or operates facilities used for sales of electric energy for resale in interstate commerce or transmission of electric energy in interstate commerce.

In some instances a holding company as defined in PUHCA may also be a public utility as defined in the FPA. As a general matter, however, the SEC regulates registered electric utility holding companies whereas the FERC regulates the operating electric utility subsidiaries of the registered holding companies. The SEC and the FERC often have responsibility to evaluate the same general matter, but from the perspective of different members of the holding company.

In regulating public utility subsidiaries of registered holding companies, the FERC historically has regulated such companies in the same way it regulates other public utilities, and has attempted to apply its ratemaking and corporate authority uniformly. In reviewing jurisdictional transactions, the FERC primarily focuses on the impact of a transaction on electric utility ratepayers and on utility operations. The SEC, on the other hand, primarily focuses on the impact of a transaction on corporate structure and investors.

There are four <u>major</u> areas of overlap in the jurisdiction of the SEC and the FERC:

(1) <u>Accounting</u> - The SEC has authority to establish accounting and reporting standards for publicly-held companies. Many of these publicly-held companies are public utilities that are also under FERC's jurisdiction and subject to FERC's accounting requirements.

(2) <u>Corporate Regulation</u> - The SEC must approve the acquisition of a public utility's securities by a registered electric utility holding company. The FERC must approve the disposition of jurisdictional facilities by a public utility.

(3) <u>Rates</u> - The SEC approves service, sales and construction contracts among associates of a registered holding company system. The FERC approves wholesale rates reflecting the appropriate costs associated with such contracts.

(4) <u>PUHCA Exemptions</u> - Under the PUHCA section 32 amendment contained in the Energy Policy Act of 1992, the FERC must determine whether an applicant meets the definition of exempt wholesale generator (EWG), and thus is exempt from PUHCA. With minor exception, the SEC continues to make PUHCA exemption determinations under the pre-Energy Policy Act PUHCA provisions as well as under the new section 33 of PUHCA.

Congress recognized the overlap in SEC-FERC jurisdiction when it simultaneously enacted PUHCA and the FPA in 1935. It included section 318 in the FPA, which provides that, if any person is subject both to a requirement of the FPA and PUHCA with respect to certain subject matters, <u>1</u>/ only the requirement of PUHCA will apply to such person, unless the SEC has exempted such

---

<u>1</u>/ These matters are: (1) issuance of securities/assumption of obligations in respect of a security; (2) method of keeping accounts; (3) filing of reports; and (4) acquisition/disposition of securities, capital assets, facilities, or any other subject matter.

person from PUHCA; if the SEC has exempted the person from the PUHCA requirement, then the FPA will apply.

During the half-century following enactment of PUHCA and the FPA, there were no significant problems resulting from the overlap in SEC-FERC jurisdiction, until a series of court decisions involving the wholesale rates of Ohio Power Company (Ohio Power). The Commissions and their staffs either were able to resolve any potential conflicts, or conflicts did not result in impairing the FERC's ability to effectively fulfill its statutory responsibility to regulate public utility rates. The Ohio Power court decisions, however, have changed this. Under these court decisions, the FERC does not have the extent of rate jurisdiction which it previously thought it had over public utility subsidiaries of registered electric utility holding companies. Rather, authority to determine certain matters affecting both wholesale and retail rates now resides exclusively with the SEC.

**The Ohio Power Company Decisions** 2/

Ohio Power Company (Ohio Power) is an operating public

---

2/ Ohio Power Company, Opinion No. 272, 39 FERC ¶ 61,098 (1987), reh'g denied, Opinion No. 272-A, 43 FERC ¶ 61,046 (1988), vacated and reversed, Ohio Power Company v. FERC, 880 F.2d 1400 (D.C. Cir. 1989) (Ohio Power I), remanded sub nom. Arcadia, Ohio v. Ohio Power Company, ____ U.S. ____, 111 S. Ct. 415 (1990) (Arcadia), order on remand, Ohio Power Company v. FERC, 954 F.2d 779 (D.C. Cir. 1992) (Ohio Power II), cert. denied, 61 U.S.L.W. 3350 (S.Ct. 1992).

utility subsidiary of American Electric Power Company (AEP), a registered electric utility holding company subject to regulation by the SEC under PUHCA. Ohio Power previously purchased coal from its wholly-owned subsidiary, Southern Ohio Coal Company (SOCCO). The SEC approved the capitalization of SOCCO by Ohio Power. In doing so, it authorized Ohio Power to pay SOCCO for the coal it produces "at cost."

The FERC, in acting on Ohio Power's 1982 wholesale rate increase, held that the cost of Ohio Power's coal purchases from SOCCO should only be reflected in wholesale electric rates to the extent that the price paid was no higher than the market price for coal of comparable quality available from non-affiliate coal suppliers. This rate decision was appealed to the United States Court of Appeals for the District of Columbia Circuit.

Two issues were presented on appeal in Ohio Power I. The first issue was whether the FERC, under section 318 of the FPA, was divested of its ratemaking jurisdiction in these circumstances because the SEC had approved Ohio Power purchasing coal from SOCCO at cost. The second issue was whether the FERC's own fuel adjustment clause regulation required it to find the coal costs reasonable based on the SEC's approval of Ohio Power's purchases of coal.

In Ohio Power I, the D.C. Circuit held that section 318 of the FPA deprived the Commission of jurisdiction to order refunds to the extent that Ohio Power paid SOCCO in excess of the market price for comparable coal. One member of the panel (J. Mikva) concurred as to the result, but did so on the basis that the Commission's fuel clause regulation compelled such a result. The Commission did not agree with the decision and sought Supreme Court review of it.

In Arcadia, the United States Supreme Court remanded the case to the D.C. Circuit, finding that under its reading of section 318, the provision did not divest the FERC of jurisdiction.

Notwithstanding the Supreme Court's finding that the FERC was not divested of jurisdiction under section 318, on remand in Ohio Power II the D.C. Circuit in effect reached the same result as it had in Ohio Power I. First, the D.C. Circuit found that the FERC's fuel adjustment clause regulation precluded the FERC from imposing its market-price test in the face of a cost-based coal price approved by the SEC. Had this been the only rationale for the court's decision, there would be no problem because the Commission could amend its fuel clause regulation. However, the court further found that the overlapping authorities of FERC and the SEC had resulted in unavoidable conflicting requirements for Ohio Power, and that Congress in authorizing the SEC to set the

price of coal "at cost" had constrained FERC from altering that price under its ratemaking authority. Once again, we disagreed, and sought Supreme Court review.

The Supreme Court denied petitions for a writ of certiorari to review the decision in Ohio Power II.

General Impact of Ohio Power II under the FPA

The D.C. Circuit's decision in Ohio Power II virtually eliminates the authority of the FERC to determine certain rate matters involving members of registered holding companies. If public utility subsidiaries of registered holding companies enter into service, sales or construction contracts with an associate company (i.e., any company in the same holding company system), the amounts paid under those contracts will be subject to the exclusive review of the SEC pursuant to section 13(b) of PUHCA. If the SEC approves a contract under which the utility agrees to pay for goods or services at the cost of its associate company, the FERC will be required to allow the costs to be recovered from ratepayers even if the utility could have obtained comparable goods or services at a lower price from a non-affiliate. These contracts can cover virtually all goods and services, except sales of electric energy or natural or manufactured gas. 3/

---

3/ See 15 U.S.C. § 79b(a)(20).

PUHCA section 13(b) requires the SEC, in approving associate contracts, to prescribe such limitations or prohibitions as necessary or appropriate in the public interest, or for the protection of investors or consumers, and "to insure that such contracts are performed economically and efficiently for the benefit of such associate companies at cost, fairly and equitably allocated among such companies." However, the SEC in the Ohio Power case did not examine whether those costs were excessive or otherwise unjust, unreasonable or imprudent from the perspective of ratepayers.

Under the Ohio Power II decision, the SEC will be solely responsible for protecting ratepayers from excessively high or imprudently incurred costs charged in affiliate service, sales, or construction transactions. It will be the forum for determining the justness, reasonableness and prudence of these costs from the perspective of ratepayers. The court in Ohio Power II, in response to ratepayer protection concerns, suggested that the FERC (and presumably state commissions) could intervene in the SEC's section 13(b) proceedings. However, to the FERC's knowledge, at this time the SEC does not undertake rate hearings, and does not appear to have the resources or procedural mechanisms for handling complaints that may arise with respect to such associate or affiliate transactions. In addition, unlike the FERC, the SEC has no authority to order refunds if it determines that it should investigate and possibly lower the

payments under an associate service, sales or construction contract which has been approved. The SEC simply does not have any mechanisms in place to provide consumer protection in these types of affiliate transactions.

The potential rate impact of the <u>Ohio Power II</u> decision extends far beyond that case. There are nine electric registered public utility holding companies. They serve, directly or indirectly, approximately 49 million households in 30 states, and provide approximately 25 percent of all power sold in the Nation. Their operations are typically built around a single highly-centralized "service" company that acts as the procurement arm for the public utility subsidiaries, and also makes both long-term and day-to-day operational decisions. Importantly, <u>Ohio Power II</u> is not limited to fuel procurement from affiliates. It affects not only goods, but also services (including operation of power plants and telecommunications services), as well as construction of power plants and transmission lines. The latter may involve millions or billions of dollars that will be recovered from electric consumers.

This situation presents a dichotomy in rate regulation of electric utilities, and the potential for higher rates for consumers served by registered holding company utilities. Those electric utilities that are members of registered holding company systems have the ability to insulate major portions of their

costs from FERC, by forming affiliates to perform services for, or sell goods to, them. Those electric utilities that are members of exempt holding companies, or that have no connection with a holding company, will continue to have all of their costs scrutinized by the FERC. If the SEC retains a cost standard for associate contracts, and does not review both the prudence of the decision to transact with an associate company as opposed to a non-affiliate company, as well as the prudence of the actual costs incurred by the company providing goods or services, there will be little incentive for members of registered holding companies to minimize costs.

Lastly, as discussed below, the Ohio Power II rationale has implications for exempt wholesale generators (EWGs) that enter into contracts with members of registered holding company systems.

Impact of Ohio Power II on Exempt Wholesale Generators

Section 711 of the Energy Policy Act of 1992, in new PUHCA section 32, creates a new entity in the electric utility industry: the exempt wholesale generator (EWG). EWGs are not electric utility companies under PUHCA and are exempt from all provisions of PUHCA. Exempt and registered holding companies can own EWGs, and ownership of an EWG will not make a person a holding company.

Most EWGs, upon the sale of electric energy, will be public utilities subject to FERC's rate, corporate and accounting jurisdiction. Ohio Power II could affect the Commission's rate regulation of those public utility EWGs that enter into certain contracts or relationships with a registered holding company, its affiliates and associate companies. Even though PUHCA section 32(e) exempts EWGs from PUHCA, section 32(h) provides that certain actions involving EWGs and registered holding companies will remain subject to SEC jurisdiction.

PUHCA section 32(h) provides, *inter alia*, that "the entering into service, sales or construction contracts, and the creation or maintenance of any other relationship in addition to [acquiring and holding the securities, or an interest in the business, of EWGs] between an exempt wholesale generator and a registered holding company, its affiliates and associate companies, shall remain subject to the [SEC's] jurisdiction" under PUHCA. This provision applies whether or not the EWG is associated with the registered holding company system with which it transacts.

If an EWG is associated with a registered holding company, the SEC will need to approve any service, sales, or construction contract between the EWG and the registered holding company and its affiliate and associate companies, and PUHCA section 13(b) will apply as interpreted in Ohio Power II. For example, assume

that a registered holding company owns an EWG that, upon the sale of electric energy, will be a public utility subject to the FERC's rate regulation, and that the registered holding company proposes to burn coal from one of its subsidiaries in the EWG's eligible facility. If the SEC approves the sales contract under PUHCA section 13(b) and provides that the sale from the coal affiliate to the EWG should be at cost, the FERC, pursuant to Ohio Power II, will be required to allow recovery of the SEC-approved coal costs, even if comparable coal from non-affiliate suppliers is available at a price below the cost-based affiliate coal.

Accordingly, if the registered holding company, public-utility EWG seeks a cost-based rate from the FERC, the Commission will be unable to reduce the rate even if it finds that the price of coal paid by the EWG to its affiliate company or associate company exceeds the market price for coal. This is the same situation discussed above regarding non-EWG public utilities.

However, most EWGs presumably will seek a market-based rate from the FERC. If the registered holding company, public utility EWG seeks a market-based rate from the FERC, other issues arise. The problem with market-based rates vis-a-vis Ohio Power II would occur as the rate operated over time. If it turned out during the contract term that the market-based rate became insufficient to permit the EWG to recover its costs of coal from its

affiliate, the EWG might argue that under Ohio Power II the FERC was required to raise the rate to a level that would at least be sufficient to break even on the cost of affiliate coal. This would be wholly inconsistent with market-based rate concepts, under which the seller and buyer specify their risks up-front and cannot later seek to change the rate or to raise confiscation arguments, based on unanticipated events.

Major Issues Related to New Legislation

If the Subcommittee considers legislation to remedy the problems created by the Ohio Power II decision, there are five fundamental issues that need to be considered. These issues have been the subject of considerable debate among various interest groups during the past year.

Single vs. dual agency review. First is the issue of whether both the SEC and the FERC should have jurisdiction to review section 13(b) transactions, or whether only one of the agencies should have such jurisdiction. Some have argued that to restore FERC review authority, and to subject registered holding companies to dual regulation, would be unduly burdensome and result in conflicting regulation. I disagree.

As explained earlier, the SEC and FERC have different purposes and different review responsibilities, even though they may be reviewing the same general matter. The SEC primarily

focuses on the impact of a transaction on corporate structure and investors, whereas the FERC primarily focuses on utility ratepayers and utility operations. Simply put, we have rate expertise; the SEC does not. In addition, the FERC has the procedural mechanisms in place, and the statutory authority to order refunds, to provide full consumer protection. I believe that restoring FERC authority to protect ratepayers of registered holding company systems is critical to the Commission's responsibilities under the FPA.

Legislation to restore FERC authority would not create new, burdensome regulation. Dual regulation has long been a fact of life for registered holding companies that have public utility subsidiaries. The 1935 Public Utility Act contemplated dual regulation in a number of areas, as discussed above. In fact, for many transactions registered companies not only have to get SEC and FERC approval, but also approvals from one or more state authorities.

A good example of long-standing dual regulation is in the merger area. For example, the SEC must approve a registered holding company's acquisition of a public utility's securities, and the FERC must approve the disposition of jurisdictional facilities by the public utility. Both approvals involve the same transaction and are necessary for the transaction to occur. (State approvals usually are also required.) The SEC could grant

approval and the FERC could deny approval, or vice versa. This results in a "conflict" in that one agency finds the transaction meets its criteria and can go forward, but the other agency does not. However, historically this has not been a problem and the holding company, the public utility, the two federal agencies, and the state commissions recognize the need for approvals by all the jurisdictional agencies. It should be no different if FERC authority over affiliate costs is restored.

While it is understandable that registered holding companies and their public utility subsidiaries would prefer to eliminate regulatory hurdles whenever possible, regulatory scrutiny is part of the responsibility that comes with the benefits of being a registered holding company with substantial public utility ownership. More importantly, if dual regulation is not restored over section 13(b) transactions, such that the FERC can regulate affiliate transactions of registered holding company utilities, there will be incentive to insulate major components of electric rates from effective scrutiny.

Which statute to amend. Options for restoring FERC authority include amendments to section 13 of PUHCA, sections 205 and 206 of the FPA, or section 318 of the FPA. Because the FPA already contains a specific section addressing conflicts between SEC-FERC jurisdiction (FPA section 318), it appears to be the most appropriate place to address the *Ohio Power* situation.

<u>State authority</u>. The <u>Ohio Power</u> court decisions do not directly address whether states are precluded from regulating at the retail level the costs incurred under section 13(b) affiliate contracts approved by the SEC. However, based on the D.C. Circuit's "trapped cost" analysis in <u>Ohio Power II</u> (discussed in the answer to Question 1 in Appendix A), it is arguable that states have no jurisdiction to preclude recovery of section 13(b) costs in retail rates. Therefore, it may be appropriate to clarify state authority in this regard. The appropriate place to clarify such authority is unclear since FPA section 318 specifically deals only with SEC-FERC preemption, and the extent of SEC-State preemption must be derived primarily from PUHCA.

<u>Grandfather clause</u>. Based on the law since 1935 and the hundreds of dual regulatory approvals obtained by registered holding companies and their public utility affiliates during the last half-century, it is a tenuous argument at best that registered holding companies ever had any legitimate reason to believe that SEC approval of an affiliate contract would preempt FERC rate authority. In this regard, the SEC staff, in a recent memorandum sent to Representative Markey, stated that prior to the <u>Ohio Power</u> decision, the SEC did not believe that the exercise of its authority under section 13 preempted FERC ratemaking authority. (February 17, 1994 memorandum from SEC Division of Investment Management to SEC Chairman Arthur Levitt,

responding to questions of Representatives Markey, Sharp and Boucher concerning telecommunications legislation.)

However, if Congress believes a grandfather provision should be included in proposed legislation, such a clause should be written narrowly to address only the circumstances addressed in the Ohio Power decision; that is, it should include only fuel-related costs. It should not include matters that extend beyond the Ohio Power situation.

Future SEC-FERC administrative action. If legislation is enacted to restore the FERC's authority to adequately regulate the rates of registered holding company public utilities, the two agencies should attempt to develop consistent policies in order to provide registered holding companies greater regulatory certainty. While different regulatory decisions related to section 13(b) contracts may not result in true "cost trapping" as the term was used by the Supreme Court in the Nantahala and Mississippi cases (see Appendix A supra), it is preferable to minimize risk for the companies and reduce regulatory conflict.

In this regard, I would note that the staffs of the FERC and the SEC have attempted in recent years to coordinate more closely regarding matters of overlapping jurisdiction. This coordination has increased since the passage of the Energy Policy Act. From

the FERC's perspective, this has been beneficial and the FERC staff will continue this coordination if the law is changed.

Summary

I urge the members of the Committee to act favorably on legislation that would restore the FERC's ability to effectively regulate the rates of public utilities that are members of registered holding companies. This would allow the FERC to undertake the same analysis of costs, and provide the same rate treatment, for this category of public utilities as it does for other public utilities.

Importantly, the FERC already has in place the procedural mechanisms, the resources and expertise to properly analyze the rate impact of registered holding company affiliate transactions. The most efficient solution, in my perspective, is not to create duplicative mechanisms and expertise at the SEC. Rather, Congress should allow the FERC to go about fulfilling its statutory responsibility to ensure appropriate rates for all public utilities. Ratepayer protection demands no less.

In addition to these general comments, I have included an appendix with responses to the specific questions raised by the Chairman's May 16, 1994 letter inviting me to testify.

I would be happy to answer any questions the Committee may have.

APPENDIX

Chair Moler's Responses to Questions from the Subcommittee

Question 1: In the Ohio Power decision, the court repeatedly referred to the term "trapped costs." That concept also was discussed in the Mississippi Power and Light decision. In the Mississippi decision, "trapped costs" referred to costs which would be allocated between ratepayers of different operating units, and ambiguities in state and federal decisionmaking; in the Ohio Power decision, the term was used to describe costs that would be allocated between shareholders and ratepayers. What policy ramifications should flow from use of the term "trapped costs"? Do you see a policy difference resulting from the different applications of the term?

Answer 1: The term "trapping of costs" originated with the Supreme Court in Nantahala Power & Light Co. v. Thornburg, 476 U.S. 953 (1986), was used again by the Court in Mississippi Power & Light Co. v. Mississippi, 487 U.S. 354 (1988), and was used by the D.C. Circuit as applying to the Ohio Power situation. However, the D.C. Circuit and proponents of the "trapped cost" argument ignore a fundamental difference between the Ohio Power situation and the situations addressed by the Supreme Court in Nantahala and Mississippi.

In both the Nantahala and Mississippi cases, the FERC not only set the wholesale rate at which public utilities were selling power to their affiliates, but it mandated that specific amounts of power be purchased. The Supreme Court in both instances found that there was no room for the states to deny pass-through in retail rates of the purchase power costs because there would be a "trapping" of costs that the purchasers had been mandated to pay. A fundamental underpinning of both decisions was that, by virtue of the FERC's orders, the purchasers had no legal choice but to procure the amount of power ordered by the FERC. As the Court stated in Mississippi:

> Just as Nantahala had no legal right to obtain any more low cost TVA power than the amount allocated by FERC, it is equally clear that MP&L may not pay for less Grand Gulf Power than the amount allocated by FERC.

487 U.S. at 374. In both instances, had the State denied pass-through, costs would have been borne by the utility shareholders.

The Ohio Power situation is in stark contrast to Nantahala and Mississippi. In the Ohio Power situation, the SEC approved a contract under which a utility would purchase coal from its affiliate. SEC approval was a pre-requisite to the transaction.

However, the SEC did not require that the holding company create the coal company subsidiary or that the public utility undertake the transaction. The holding company and its utility subsidiary had the legal right to choose whether to purchase coal should from an affiliate or a non-affiliate. Thus, there is no "trapping of costs" as the term was used by the Court in Nantahala and Mississippi.

Opponents of legislation to restore the FERC's authority make "trapped costs" arguments which go far beyond the situations in Nantahala or Mississippi. Under the theory of these arguments, costs incurred under a contract receiving any type of regulatory approval must be guaranteed recovery and a public utility can be shielded from all accountability as to the prudence of the costs incurred. This flies in the face of long-standing FERC and state ratemaking review. Simply put, costs are not "trapped" if the public utility incurring the costs has legal freedom of choice to incur the costs. Legislation would not create "trapped" costs.

Question 2: Assuming FERC has problems with its post-Ohio Power role, what legislative remedy would the Commission propose? Would FERC support legislation to restore the Commission's full authority to review interaffiliate purchases of goods and services, regardless of any prior determination by the Securities and Exchange Commission (SEC) -- essentially to restore the agencies' respective roles prior to the court's decision?

Answer 2: FERC would support legislation to restore the Commission's full authority to review interaffiliate purchases of goods and services by public utility members of registered holding company systems, regardless of any prior determination by the SEC. This would result in the rates of these public utilities being regulated in the same way as the rates of all other public utilities.

Question 3: If legislation restoring the Commission's pre-Ohio Power authority were crafted to apply only to future contracts, how many existing contracts would be affected -- in other words, how many contracts affecting interaffiliate purchases would FERC be precluded from reviewing?

Answer 3: The Commission does not have the information to determine how many contracts would be affected if the Commission's authority were restored only as to future contracts. Since the time of the Ohio Power decision, the SEC may have approved numerous affiliate contracts under section 13(b) of PUHCA. However, costs may not yet have been incurred by the

public utility pursuant to the approved contracts or, even if incurred, the public utility may not yet have sought rate recovery. In addition, if the SEC approved an affiliate contract under section 13(b) prior to the new legislation, costs could continue to be incurred, pursuant to the approved contract, indefinitely into the future.

While the Commission cannot determine the number of contracts approved by the SEC from the time of Ohio Power until the time of new legislation, two cases since the issuance of Ohio Power II have been affected by the decision:

> Municipal Resale Service Customers v. Ohio Power Company, 62 FERC ¶ 61,207, reh'g denied, 64 FERC ¶ 61,034 (1993), appeal pending, (6th Cir.). This case concerned a complaint filed by a group of municipal customers against Ohio Power Company (Ohio Power). The municipal customers challenged the recovery in rates of allegedly excessive costs incurred by Ohio Power in purchasing coal from two affiliated mines, Meigs and Muskingum. 1/ Finding that this case and the Ohio Power proceeding were "for all relevant purposes . . . identical," FERC -- referring to Ohio Power II -- concluded that it was without authority to order relief and rejected the complaint.

> Indiana Michigan Power Company, Opinion No. 382, 62 FERC ¶ 61,189, reh'g denied, Opinion NO. 382-A, 65 FERC ¶ 61,087 (1993), appeal pending, (D.C. Cir.). Phase II of this case concerned allegations that, among other things, Indiana Michigan Power Company (Indiana Michigan) 2/ was overpaying its affiliates for coal transportation facilities (rail cars, towboats, barges, and a rail-to-barge coal transloading terminal). FERC found that, in light of Ohio Power II and the fact that the affiliate coal transportation costs were subject to SEC jurisdiction, the Commission was without authority to address the reasonableness of the coal transportation costs. The Commission concluded that review of the reasonableness of these costs was within the exclusive jurisdiction of the SEC.

---

1/ The Ohio Power proceeding involved Ohio Power purchases of coal from another affiliated mine, Martinka, that has since been sold.

2/ Indiana Michigan, like Ohio Power Company, is a public utility subsidiary of the American Electric Power Company, a registered holding company.

Question 4: Prior to the Ohio Power decision, did registered holding companies voice dissatisfaction about the Commission's authority to review interaffiliate purchases, or otherwise object to the then applicable interpretation of FERC and the SEC's respective authorities under the Public Utility Holding Company Act of 1935?

Answer 4: There is only one case of which we are aware, prior to Ohio Power, in which registered companies formally objected to the Commission's jurisdiction: McDowell County Consumers Council, Inc. v. American Electric Power Company, et al., 54 FPC 361 (1975). The FPC instituted an investigation of, among other things, affiliate coal procurement policies and practices across the entire registered holding company. The FPC did so despite express allegations that the SEC had authority to regulate affiliate coal prices, explaining that the investigation was being instituted "for the purpose of fulfilling this Commission's statutory obligation as expressed in Sections 202, 205, 206, 301, 306, 307 and 309 of the Federal Power Act." 3/

---

3/ A case which grew out of this investigation was American Electric Power System; McDowell County Consumers Council, Inc. v. American Electric Power Company, et al., 31 FERC ¶ 61,239 (1985). This case concerned purchases of coal by Indiana Michigan from affiliated coal mines in Utah. Commission trial staff alleged that, from the beginning of 1982 through the end of 1984, ratepayers paid roughly $42 million in excess of market prices for this coal. The case subsequently settled. The settlement, among other things, provided for refunds of $21 million to be paid to ratepayers and a future market price cap for this coal. At roughly the same time this case was first being litigated and then settled, another case similarly addressing affiliate fuel costs and involving another public utility subsidiary of the American Electric Power Company, Appalachian Power Company, was also being litigated and settled. Appalachian Power Company, 28 FERC ¶ 61,286 (1984).

Mr. SHARP. As I believe the people heard the bells, we have a vote on the House Floor at this moment going on, so I think what we will do is take about a 10-minute break and we will hear from Mr. Roberts.

[Brief recess.]

Mr. SHARP. The subcommittee will come to order. We are pleased now to hear from Commissioner Roberts.

## STATEMENT OF RICHARD Y. ROBERTS

Mr. ROBERTS. Thank you, Chairman Sharp and members of the subcommittee. With me to my left is Bill Weeden, Associate Director at the SEC's Division of Investment Management. He has been in charge of the SEC's public utility regulation program for a number of years. Bill obviously is much more familiar with the historical details of the Ohio Power decision than I am.

I do appreciate the opportunity to testify on behalf of the SEC regarding the policy issues presented by the judicial decision in Ohio Power and other issues more generally related to the framework of regulation under the Public Utility Holding Company Act of 1935, which I will refer to throughout today as PUHCA, or the Act, and the Federal Power Act.

There are concerns that the Ohio Power decision will challenge the ability of the Federal Energy Regulatory Commission and of State and local utility commissions to protect consumers through traditional rate-making proceedings.

The SEC shares these concerns and is committed to resolving these concerns in a satisfactory manner consistent with its mandate under the act to protect the public interest and the interest of investors and consumers.

Further, over and above the immediate Ohio Power concerns, the SEC is of the view that it is time to revisit PUHCA in general and in doing so, to consider how Federal regulation of registered public utility holding companies can best serve the public interest and the interest of investors and consumers as we approach a new century.

To accomplish these objectives, the SEC today is announcing two new initiatives. First, without waiting any longer for a legislative solution, the SEC has initiated work on a rulemaking that would apply the lower of cost or market standard to all intrasystem service, sales, and construction contracts.

The goal of such a rule would be to ensure that intrasystem transactions are conducted at the lowest possible price. The SEC intends to consult with the FERC and with the States in fashioning this rule.

If implemented, the rule may remedy most, if not all, of the Ohio Power concerns administratively.

Second, the SEC intends to embark upon a comprehensive study of PUHCA in light of the apparent need for modernization of the act. It is envisioned that the study will consider what reforms are necessary, and will determine the appropriate regulatory or legislative recommendations to pursue accordingly.

Among other things, this study will consider the various proposals for registered holding companies to diversify their investments into non-utility businesses balanced against the need for investor and consumer protection.

As a part of the study process, the Commission will actively seek the views of Congress, the industry, interested consumer groups, and our Federal regulators, both on the State and Federal level on the issues considered.

Again, I wish to thank Chairman Sharp and the members of the subcommittee for the opportunity to testify. I would be pleased to attempt to answer your questions.

Mr. SHARP. Thank you very much.

[Testimony resumes on p. 49.]

[The prepared statement of Mr. Roberts and responses to subcommittee questions follow:]

**TESTIMONY OF RICHARD Y. ROBERTS**
**COMMISSIONER**
**U.S. SECURITIES AND EXCHANGE COMMISSION**

**CONCERNING THE POLICY ISSUES PRESENTED BY THE OHIO POWER CO. v. FERC DECISION**

**BEFORE THE SUBCOMMITTEE ON ENERGY AND POWER**
**COMMITTEE ON ENERGY AND COMMERCE**
**U.S. HOUSE OF REPRESENTATIVES**

**May 26, 1994**

Chairman Sharp and Members of the Subcommittee:

I appreciate this opportunity to testify on behalf of the Securities and Exchange Commission ("Commission" or "SEC") regarding the policy issues presented by the judicial decision in Ohio Power Co. v. FERC, 954 F.2d 779 (D.C. Cir.), cert. denied, 113 S. Ct. 483 (1992), and other issues more generally related to the framework of regulation under the Public Utility Holding Company Act of 1935 ("Act") and the Federal Power Act ("FPA"). I understand that there are concerns that the Ohio Power decision can be read to challenge the ability of the Federal Energy Regulatory Commission ("FERC"), and state and local ratemakers, to protect consumers through traditional ratemaking proceedings. The Commission is committed to resolving these concerns within the mandate of the Act, an Act which Congress has charged the Commission with the responsibility to administer. Over and above the immediate Ohio Power concerns, the Commission believes that it is time to revisit the Act in general and, in doing so, to consider how federal regulation

of utility holding companies can best serve the public interest and the interest of investors and consumers as we approach a new century.

I. THE OHIO POWER DECISION

As a preliminary matter, let me state that Ohio Power arose in special circumstances that are unlikely to recur. In the 1970's, a number of electric utilities that relied upon coal to meet their growing fuel needs encountered great instability in the price and supply of coal. To ensure a stable and secure fuel supply, many companies sought to acquire captive coal mining operations.1/ During this period, the SEC authorized Ohio Power Company, a public-utility subsidiary of American Electric Power Company, a registered holding company, to acquire such operations.2/

In its 1971 order, the Commission authorized Southern Ohio Coal, a subsidiary of Ohio Power, to sell its coal to the utility at a price based upon the actual cost of production, including overhead, interest charges, and a reasonable rate of return on the parent company's investment.3/ Subsequent orders stated that the price would "not exceed cost."4/

---

1/ See generally Competition in the Coal Industry, Report of the United States Department of Justice (March 1982).

2/ Ohio Power Co., Holding Co. Act Release No. 17383 (Dec. 2, 1971). The order was issued following notice and a request for comments; there were no interventions or requests for hearing.

3/ Id. See rule 91 under the Act (concerning determination of cost).

4/ See Southern Ohio Coal Co., Holding Co. Act Release No. 20515 (Apr. 24, 1978); Holding Co. Act Release No. 21008 (Apr. 17, 1979); Holding Co. Act Release No. 21537 (Apr. 25, 1980).

During the 1970's, the FERC applied a rate-of-return methodology that was similar to the SEC's cost-based pricing methodology. In 1981, however, the FERC adopted a market-based standard for pricing captive coal.5/ Under the market standard, a utility that purchases coal from an affiliate can recover only the price it would have paid under a comparable coal supply contract with a nonaffiliate.6/ In 1982, when Ohio Power filed wholesale rate increases, the FERC challenged the pass-through of coal costs that did not satisfy a "comparable market" test.7/ The FERC determined that Ohio Power had paid substantially more than a comparable market price for coal supplied by Southern Ohio, and so ordered Ohio Power to establish lower wholesale rates and to refund previous overcharges.

On appeal to the Court of Appeals for the District of Columbia Circuit, the parties agreed that section 318 of the FPA governed the dispute. Under that section, when a company is subject to conflicting regulation under the Act and the FPA "with respect to the same subject matter," the requirements of the Act control. The Court of Appeals found that the two agencies were regulating the same subject matter, and that section 318 therefore required the

---

5/ See Opinion 133, Public Service Co. of New Mexico, 17 F.E.R.C. ¶ 61,123 (1981), reh'g denied, 18 F.E.R.C. ¶ 61,036 (1982), aff'd, 832 F.2d 1201 (10th Cir. 1987).

6/ Arcadia v. Ohio Power Co., 498 U.S. 73, 76 (1990).

7/ Ohio Power Co., 39 F.E.R.C. ¶ 61,098 (1987). Southern Ohio had begun mining operations in 1978.

FERC to defer to the SEC's approval of a cost-based price for the Southern Ohio coal.8/

The FERC and the SEC, believing that section 318 would resolve any inter-agency jurisdictional conflict, asked the Supreme Court to remand the case to determine whether there was, in fact, a conflict between the regulatory requirements of the FPA and the Act. The Court, however, held that section 318 did not address the type of overlapping regulatory jurisdiction affecting Ohio Power, and so remanded the case to the Court of Appeals to determine, among other things, whether "the FERC-prescribed rate is not 'just and reasonable' because it 'traps' costs which the government itself has approved -- disregarding a governmental assurance, possibly implicit in the SEC approvals, that Ohio Power will be permitted to recoup the cost of acquiring and operating [Southern Ohio Coal]."9/

The Court of Appeals, on remand, did not resolve the equitable "cost-trapping" concerns. Instead, the court found, as a matter of law, that the FERC could not set rates that would "trap" the SEC-approved fuel cost.10/ The court reasoned that the specific language of the SEC orders under section 13(b) of the Act required Ohio Power to pay a price "equal to cost" for Southern Ohio coal, and concluded that Congress granted the SEC exclusive

---

8/ Ohio Power Co. v. FERC, 880 F.2d 1400 (D.C. Cir. 1989).

9/ Arcadia v. Ohio Power Co., 498 U.S. at 85 (citations omitted).

10/ Ohio Power Co. v. FERC, 954 F.2d at 786.

authority to establish prices for transfers of goods between companies in a registered holding company system.11/

## II. THE EFFECTS OF OHIO POWER

Because Ohio Power has generated controversy, it is important to explore its ramifications. Concerns have been expressed that the Ohio Power decision has eroded FERC ratemaking capacity. Although there is also a perception that state ratemaking may be affected by the decision, Ohio Power does not address state regulation.12/ This perception is all the more troubling because the Commission did not previously believe that the exercise of its authority under section 13(b) preempted federal and state ratemaking authority. Indeed, many of the Commission's orders, prior to the Ohio Power decision, disclaimed the intent or authority to engage in ratemaking. For example, in a 1978 decision, the Commission explained that "our control over [holding

---

11/ Id. at 785. The FERC's action would, in effect, have imposed a lower-of-cost-or-market standard for the coal transfers.

12/ Prior to Ohio Power, it appears the states did not consider themselves required to pass through, in rates, costs associated with a transaction subject to section 13. In one matter, for example, the Arkansas Public Service Commission expressly rejected the argument that a determination under section 13 of the Act, concerning the formation of a service company, precluded review of the service company's billing to an associate public utility company in a retail rate proceeding. The Arkansas Commission concluded that "the Holding Company Act deals only with assuring that there is a fair allocation of service company costs among system operating companies, at cost. This function of the SEC in no way limits the ratemaking jurisdiction of state commissions." In the Matter of the Motion of Staff of the Arkansas Public Service Commission to Establish a Docket to Determine the Reasonableness of Arkansas Power And Light's Rates. Docket No. 84-199-U (Apr. 3, 1985); see also Hawes, Utility Holding Companies §11.02 (1984).

companies] relates only to their structure, to their intra-system transactions, and to their finances. We have no power over their dealing with their customers, retail or wholesale."13/

The central purpose of section 13 is "to prevent the milking of operating companies in the interest of the controlling holding-company groups."14/ Section 13(b) incorporates these principles by requiring that intrasystem service, sales and construction contracts be performed in accordance with terms, conditions, limitations and prohibitions prescribed by the Commission to "insure that such contracts are performed economically and efficiently for the benefit of such associate companies at cost, fairly and equitably allocated among such companies."

Prior to the passage of the Act, the fees and profits associated with intrasystem transactions were often "dictated by the holding company sitting on both sides of the transaction" and so, "in no way represent[ed] bargains freely and openly arrived at by subsidiary companies on the basis of the lowest cost in a competitive market."15/ The reports that gave rise to the Act recommended a cost standard for all service, sales and construction contracts

---

13/ American Electric Power Co., 46 S.E.C. 1299, 1323 (1978). See also Indiana & Michigan Electric Co., Holding Co. Act Release No. 19985 (Apr. 14, 1977) ("nothing in this order shall be construed as in any manner affecting the jurisdiction of any other regulatory authority with respect to rates, accounting or similar matters in connection with the proposed transaction.").

14/ See S. Rep. No. 621, 74th Cong., 1st Sess. 34 (1935).

15/ Report of the National Power Committee, S. Doc. No. 137, 74th Cong., 1st Sess. 5 (1935).

not performed by independent companies. To that end, the Commission's rules impose a cost standard for intrasystem transactions. With respect to transfers of seller-produced goods, however, rule 92 prescribes a lower-of-cost-or-market standard.

In Ohio Power, the company, by requesting orders, effectively sought a variance from the lower-of-cost-or-market standard. The Commission believes that the orders, which authorized the transfer of coal "at cost" were appropriate at the time they were issued. Captive coal operations were thought desirable to provide a stable and secure fuel supply to system operating companies. Both investors and consumers were expected to benefit.16/ These underlying assumptions, however, were called into question when, in 1981, the FERC changed from a cost-based methodology to a market-based standard for determining rate of return. Hindsight suggests that better communication between the two regulators at that time could have averted an unfortunate judicial decision.

The full effect of the Ohio Power decision is still unclear. Notwithstanding the decision in its favor, Ohio Power itself is engaged in settlement negotiations with state and federal ratemakers. The Commission believes, however, that to the extent Ohio Power can be read to challenge the

---

16/ In permitting Ohio Power to acquire coal mining operations, the SEC found that such operations were reasonably incidental, or economically necessary or appropriate to the operations of the integrated public-utility system of AEP. See sections 9, 10 and 11 of the Act.

ability of state and federal regulators to protect consumers, the decision is cause for concern.

III. COMMISSION ACTION TO ADDRESS OHIO POWER

The Commission has embarked upon three steps to ameliorate the concerns raised by Ohio Power. First, the Commission staff overseeing the Act has met with staff members of FERC and representatives of the National Association of Regulatory Utility Commissioners to discuss their concerns and possible solutions.

Second, in response to the concerns expressed by FERC and the states, the Commission beginning last summer attempted to arrive at a joint legislative solution with FERC. In early March, the Commission approved a joint SEC-FERC staff proposal to amend section 318 of the FPA, a copy of which is attached as Appendix A, that would have expressly authorized the FERC to disallow costs incurred pursuant to section 13(b) "if it determines that recovery of such costs would be inconsistent with the requirements of sections 205 or 206 of the Federal Power Act." Under the proposal, there would have been a rebuttable presumption that such costs are just, reasonable and not unduly discriminatory or preferential within the meaning of the FPA. The legislation would have also "grandfathered" any fuel-related costs incurred pursuant to a transaction authorized under section 13(b) prior to the date of the legislation. It is my understanding that this joint proposal is now not entirely satisfactory to FERC.

Third, rather than continue to struggle in search of an appropriate legislative solution, it is now the Commission's intention to seek an administrative solution to the problems created by the Ohio Power decision. The Commission has instructed the staff to draft a rule proposal for public comment that would apply a lower-of-cost-or-market standard to intrasystem service, sales and construction contracts.17/ The Commission would encourage the FERC and the states to assist us in our rulemaking so as to address their ratemaking concerns. If adopted, the rule would appear to moot most, if not all, of the Ohio Power concerns by ensuring that intrasystem transactions are conducted at the lowest possible price, thereby harmonizing the Commission's standard with that used by the FERC, and minimizing the possibility of additional "trapped costs" problems. While the Commission is aware that other legislative proposals are being considered, it is now of the view that pursuit of a regulatory "fix" under its existing authority would best serve both investors and consumers.

## IV. MODERNIZATION OF PUHCA

The dialogue concerning possible legislative solutions to Ohio Power has given rise to other questions about other aspects of the Act. Since the Act

---

17/ In recent audits, the Commission staff has required a comparison of market- and cost-based pricing for a representative sample of services performed for associate companies transactions. The Commission suggested in testimony last spring that the problem could be addressed administratively. Statement of the U.S. Securities & Exchange Commission Concerning S. 544, The Multistate Utility Company Consumer Protection Act of 1993, Before the Senate Committee on Energy and Natural Resources (May 25, 1993).

became law in 1935, there have been sweeping changes in the electric and gas utility industry, and concomitant changes in the regulation of the industry. Holding companies seeking to expand their business horizons have sought changes in the Act to accommodate this expansion.

Most recently, the diversification authorized by the Energy Policy Act of 1992 has provided more investment flexibility to holding companies, while charging the Commission with the primary responsibility of protecting the interests of consumers from the adverse effects of new ventures.18/ In response to the enactment of this legislation, the Commission has adopted rules that are intended to shield consumers and investors from the potential adverse effects of these investments.19/ It has also proposed rules relating to holding company investments in foreign utility companies.20/ It is too early, however, to comment on whether the new ventures have been successful, and whether diversification permitted under the Energy Policy Act would result in any potential adverse impact on investors or ratepayers.

Beyond the Energy Policy Act of 1992, I understand that there are currently pending other initiatives to permit further diversification into nonutility investments such as telecommunications. Chairman Levitt in a letter to you Chairman Sharp, and to Congressmen Markey and Boucher, indicated

---

18/ Pub. L. No. 102-486, 106 Stat. 2776 (1992).

19/ Release No. 35-25886, 58 Fed. Reg. 51488 (Oct. 1, 1993).

20/ Release No. 35-25757, 58 Fed. Reg. 13719 (March 15, 1993).

that such diversification would raise serious concerns about investor and consumer protection. The recent experience with utility company diversification has not been all positive, as evidenced by the experiences of exempt holding companies, such as Pinnacle West Capital Corporation, Pacific Enterprises (the parent of Southern California Gas Company), Florida Power & Light Company, and Hawaiian Electric Industries, Inc.

It is difficult to assess the merits of diversification in isolation of other related issues underpinning the Act. The provisions of PUHCA were drafted with care almost 60 years ago to strike a careful balance between investor protection and industry flexibility. To address one aspect without consideration of an appropriate balance to address the whole would be inappropriate. The Commission believes that it is now time to consider, among other things, how corporate and financial regulation under the Act can more effectively protect investor and consumer interests, in coordination with the efforts of the FERC and state and local regulators, while at the same time search for areas where unnecessary or ineffective safeguards can be removed. To accomplish these objectives, the Commission proposes to conduct a comprehensive study of the Act to consider all issues related to modernization of the regulatory framework. It is envisioned that a staff study, conducted in conjunction with a roundtable of industry participants and in close coordination with other regulators, will produce a series of legislative and regulatory recommendations to achieve a more efficient and cost-effective regulatory approach. The Commission will

also consider how best to administer the Act in light of the current economic and regulatory environment, including an examination of whether Commission resources in this area are sufficient.

Again, I wish to thank Chairman Sharp and the members of the Subcommittee for this opportunity to testify. The responses to the questions in the Chairman's letter of May 16, 1994 are set forth in Appendix B. I would be pleased to answer any questions at this time.

APPENDIX A

Proposed Amendment to section 318 of the FPA:

Section 318 of the Federal Power Act is amended by inserting "(a)" after "Sec. 318" and by adding the following new subsection at the end thereof:

(b) Notwithstanding any other provision of the Federal Power Act or the Public Utility Holding Company Act of 1935, the Federal Energy Regulatory Commission shall have authority to disallow recovery in jurisdictional rates of any costs incurred by a public utility pursuant to a transaction that has been authorized under section 13(b) of the Public Utility Holding Company Act of 1935, if it determines that recovery of such costs would be inconsistent with the requirements of sections 205 or 206 of the Federal Power Act.

(c) In any proceeding of the Federal Energy Regulatory Commission to consider the recovery of costs described in subsection (b) --

(1) there will be a rebuttable presumption that such costs are just, reasonable and not unduly discriminatory or preferential within the meaning of the Federal Power Act; and

(2) the Federal Energy Regulatory Commission shall not disallow any fuel-related costs incurred pursuant to a transaction that was authorized under section 13(b) of the Public Utility Holding Company Act of 1935 prior to the date of enactment of this provision.

APPENDIX B

**Question 1. In the Ohio Power decision, the court used the term "trapped costs." That concept also was discussed in the Mississippi Power and Light decision. In the Mississippi decision, "trapped costs" referred to costs which would be allocated between ratepayers of different operating units, and ambiguities in state and federal decisionmaking; in the Ohio Power decision, the term was used to describe costs that would be allocated between shareholders and ratepayers.**

**Do you see a policy difference resulting from the different applications of the term? What policy ramifications should flow from use of the term "trapped costs"?**

Response: It appears that the Supreme Court has used the term "trapped costs" to describe two different types of issues. Most recently, in its Ohio Power decision, the Court used the term to denote an equitable concern that a FERC-prescribed rate would not be "just and reasonable" if it trapped costs "disregarding a governmental assurance, possibly implicit in the SEC approvals, that Ohio Power will be permitted to recoup the cost of acquiring and operating [Southern Ohio Coal]." 1/

The Supreme Court used the term in a different sense in earlier decisions. In Nantahala Power & Light Co., 476 U.S. 953 (1986) and Mississippi Power & Light Co. v. Mississippi, 487 U.S. 354 (1988), the question was whether states could refuse to pass through to consumers, and so "trap," certain FERC-approved costs. In these cases, which did not involve the SEC, the issue of "trapped costs" was addressed in the context of the Supremacy Clause, a constitutional issue. The Supreme Court held that, under the Supremacy Clause, FERC-mandated allocations are binding on the states, and the states must treat those allocations as fair and reasonable when setting retail rates.

The different applications of the term "trapped costs" appear to implicate different policy considerations. In Ohio Power, the issue was one of fairness; in Mississippi and Nantahala, the question was one of federal preemption. This distinction has been somewhat blurred in the current debate. The states, in particular, are concerned that SEC action will preempt their ratemaking authority. The Act, however, was not intended to oust the states from their jurisdiction over operating companies.

**Question 2. Would the Commission oppose legislation restoring FERC's authority to review interaffiliate contracts for purchases of goods and services? If so, please explain why and the extent to which any concerns relate to the Commission's ability to fulfill its responsibilities under the Public Utility Holding Company Act of 1935 (PUHCA).**

Response: The Commission has approved a joint SEC-FERC staff proposal that would amend section 318 of the FPA to address Ohio Power concerns, and restore FERC ratemaking authority. The Ohio Power decision is cause for concern and should be addressed. In this regard, the Commission staff is working on a rule that would apply a lower-of-cost-or-market standard to transactions under section 13(b).

If the Subcommittee determines that legislation is desirable, the SEC would be pleased to address the merits of any proposals and to assist in any way possible, including making staff available to provide technical assistance.

---

1/ Arcadia v. Ohio Power Co., 498 U.S. at 85 (citation omitted).

**Question 3. Regarding legislation to restore FERC's authority, please describe the Commission's position on the following issues. For each, please explain whether and how any concerns relate to the Commission's ability to fulfill its responsibilities under PUHCA:**

**a. should such legislation apply only to existing contracts?**

Response: This is a difficult question, which will require a balancing of the various interests. While there would appear to be no problem if the legislation were to apply prospectively, any action that would affect existing contracts is likely to be the subject of litigation.

**b. should such legislation establish a rebuttable presumption with respect to either the Commission or FERC's decision on costs, and if so why?**

Response: The joint SEC-FERC staff proposal would create a rebuttable presumption that costs incurred pursuant to section 13(b) recovery of such costs are just, reasonable and not unduly discriminatory or preferential within the meaning of the FPA. This provision was intended to mirror the FERC's practice prior to the Ohio Power decision, and to preserve the integrity of each agency's determinations.

As explained more fully in the answer to question 4, below, the SEC and the FERC consider intrasystem service, sales and construction transactions from different perspectives. While the FERC is primarily concerned with the pricing of an interaffiliate transaction and the effect on a utility's wholesale rates, the SEC is concerned with intrasystem financial abuses and so regulates these transactions "to prevent the milking of operating companies in the interest of the controlling holding-company groups." 2/

It is our understanding that the FERC is considering a rulemaking that would expressly provide a rebuttable presumption for fuel costs that are approved by another regulatory body. In its proposing release, the FERC stated that it could give deference to another regulatory body and still fulfill its statutory obligation. 3/

**Question 4. To the extent not addressed in response to prior questions, does the Commission have any concerns about the fairness of subjecting utilities to review of interaffiliate purchases by both the SEC and the FERC? If so, why, and bow do any such concerns relate to the Commission's responsibilities under PUHCA?**

Response: Clearly, a system under which different agencies review the same transaction under similar standards is inefficient, and creates the possibility of inconsistent results. It is the Commission's understanding, however, that the FERC and the SEC approach interaffiliate transactions from different perspectives. Congress enacted the Federal Power Act to regulate the wholesale interstate sale and distribution of electricity, and so, the FERC is concerned in the first instance with operational issues. The FERC, thus, is primarily concerned with the pricing of an interaffiliate transaction and the effect on a utility's wholesale rates. In contrast, the Public Utility Holding Company Act was intended to address financial abuses among public utility holding companies and their affiliates. Thus, the SEC regulates interaffiliate transactions, in the first instance, to prevent financial abuses such as misallocation of costs. In addition, the Commission also considers such issues as diversion of personnel and other means of cross-subsidization.

As noted above, there have been fundamental changes in the electric and gas utility industry and in the regulatory framework over the past sixty years. In view of these developments, the Commission believes it is appropriate to undertake a thorough study of the Act.

---

2/ See S. Rep. No. 621, 74th Cong., 1st Sess. 34 (1935).

3/ Revision of Fuel Cost Adjustment Clause Regulation Relating to Fuel Purchases from Company-Owned or Controlled Source, 58 F.R. 51259 (Sept. 24, 1993).

Mr. SHARP. The Chair recognizes himself now for 5 minutes.

Ms. Moler, would you elaborate on a couple issues? One, it has been suggested to us that if we legislate, that we should make a distinction between goods and services in terms of what can be reviewed in a prudence review, and I think some of the proposals are to exclude services.

Can you help us understand what that distinction would mean and do you or the Commission have an opinion on that?

Ms. MOLER. The Commission has not formally addressed this issue. Personally, the logic of the D.C. Circuit's opinion in the Ohio Power case would apply to several areas of FERC jurisdiction, so I think if you were to deal with this issue, you should deal with it broadly.

I see no reason that the FERC should not be able to review from a ratemaking perspective intracorporate transactions, whether they be for goods, services, fuel purchase, or the like. They all have the same ratepayer impact. They are all transactions between affiliates and therefore in my view require scrutiny.

Mr. SHARP. In terms of the grandfather issue that you raised in your testimony, you were indicating that—I think you indicated the possibility of grandfathering. In other words, preventing review of fuel transactions. Am I correct in what you said?

Ms. MOLER. That is correct.

Mr. SHARP. Can you help us understand why you would make that distinction?

Ms. MOLER. I would like to draw the grandfather clause as narrowly as possible, and that view stems from my general notion that the Ohio Power decision was wrong as a matter of policy as well as a matter of law.

So if you were to give protection for a class of transactions, I believe the public interest would be served the best by narrowing the group of transactions that are protected from our review.

Mr. SHARP. Am I correct that the—both the decision to use the market test in coal, which I believe came in, was it 1981 by the Commission, and then the application of that policy to this specific case were done by the appointees of President Reagan; is that correct? Most of them would have been. At least the majority would have been.

Ms. MOLER. Sir, I am a Reagan appointee, so I don't necessarily think that is bad. The first establishment of the market test was in a 1981 case involving the Public Service Company of New Mexico. So that would have been Reagan appointees, yes, and it was affirmed in 1986 as well, but it certainly——

Mr. SHARP. That isn't the most relevant question here obviously, but I just wanted to—there are folks that like to pretend like somehow this all comes out of left field when these kind of decisions get made, and I think it behooves us to politically understand that is not the relevant question.

Can you help us understand? Do you know that history? You were not on the Commission at that time. Can you help us understand the reasoning of the Commission that it should raise the question of the market test on coal and then apply it retrospectively?

Ms. MOLER. The Commission has gone to a market test in a number of instances. There have been sort of a series of transactions and rulemakings.

Basically the notion is that where a market exists, and it is a competitive market, consumers are best protected by looking at other transactions in that same marketplace for determining what is a reasonable price and what a prudent utility would do.

If you look instead at the cost that a utility has for goods and services it buys, and if those costs are way in excess of what other competitive market transactions are providing, then it calls into question what the utility is doing with its affiliate.

If you have a captive coal company, and as you observed in your opening statement, the rates charged by the captive coal company are 90 or 100 percent in excess of the rates charged by other coal companies for the same fuel, it makes one question whether that is a prudent purchase on the part of the utility.

Mr. SHARP. Do you happen to know in this case whether there was an effort for the affiliate and the purchaser to—the supplier and the purchaser in the Ohio Power case to renegotiate that contract?

Ms. MOLER. I personally don't know the answer to that question. I don't believe so, and in the testimony that is presented to you later today by the company involved, they do not describe any attempt to buy out or buy down the contract.

Had they done so and had they notified the Commission that they were doing so, I believe the Commission would have allowed them to pass through the costs of buying down the contract so that the net result would not have been harmful to the company. It would not have been trapped costs and over the long haul, and the ratepayers would have benefited.

We certainly would do that with other contracts. We do it all the time where there are investments that are made, contracts that are entered into. The world changes. If it is prudent to get out of those contracts, renegotiate them, we allow the pass-through of prudently incurred costs in renegotiating contracts.

Mr. SHARP. And what kind of incentives would the intracompany arrangement have to renegotiate if there is no prudence review?

Ms. MOLER. Very few.

Mr. SHARP. I mean, obviously if we get a radically competitive power market, one would hope that at some point that would come to bear on the system, but——

Ms. MOLER. They presumably would not have any new business opportunities in the new competitive generation market, and the difficulty of course would be that their State utility commission, because of the way the Ohio Power decision ripples through the system, would also have no ability to touch those costs.

Mr. SHARP. Mr. Roberts, does the SEC review the question of costs in the affiliate contract when they give it the approval?

Mr. ROBERTS. Yes.

Mr. SHARP. Does it ever come back and reexamine whether the costs were appropriate?

Mr. ROBERTS. We have reallocated costs in the past on numerous occasions.

Mr. SHARP. That is based on somebody coming in with a complaint?

Mr. ROBERTS. It could be various factors.

Mr. WEEDEN. The staff has an ongoing auditing program, albeit a small number of people, and over the last 4 years, for example, approximately $68.5 million of misallocated costs were required to be reallocated and inefficiencies that were picked up in these audits required to be corrected.

No, we didn't write refund checks. We don't do that. But what we do do is bring the States in and the FERC in to our audits, and let them know what our findings have been, what the deficiencies have been, and then through the various mechanisms of a fuel adjustment clauses, et cetera, et cetera, these costs have been reallocated back to the appropriate jurisdictions.

Mr. SHARP. But you said it is obviously a very small staff. It is not just a normal course of action to be reviewing—you obviously don't have rate cases——

Mr. WEEDEN. Beg your pardon?

Mr. SHARP. You obviously don't have rate review cases.

Mr. WEEDEN. No, we do not, sir, but we try to work with all the States and the FERC and if any of those agencies ever had a complaint and wanted us to revisit something, I can't imagine us not going to the Commission and saying, let's take a look at this previous contract or previous application, whatever it was.

Mr. SHARP. Is this done with hearings and interveners raising these issues——

Mr. WEEDEN. Our culture has tried to be where we get the groups together to work these problems out. We do have administrative law judges. We have had hearings in the past, albeit we don't do it on a standard case by case basis as FERC does. We do not.

Mr. ROBERTS. Chairman Sharp, this is really a resource issue. We have about 20 professionals that are in charge of administering the SEC's Public Utility Holding Company Act program.

Obviously hearings, on a consistent basis, would take too much in the way of those resources. We could reallocate resources within the SEC, for example, by taking them out of our enforcement division, or taking them out of our investment adviser inspection area. I do not think that such a course of action represents a very workable solution.

So we do do the best that we can, given the limited resources that are available. Having hearings does not fit very cleanly into that resource equation. We have had a few over the years, very few.

Mr. SHARP. Well, I think what you are telling us just reconfirms the expectation that Congress has had that you were not going to be carrying out the ongoing function of reviewing whether costs should be passed on to consumers, that that was not the central function and job, and that therefore we have allocated more resources, more legal authority to the FERC to carry out that series of functions over many, many years.

Mr. ROBERTS. There is no question that we do depend on the FERC and will continue to in the future. We also, as a part of the study, will look at alternatives to increase our resources.

Mr. SHARP. Ms. Moler, how does this proposition square? Can you folks then take what course of action you wish? If they decide to cross them and misallocate it, how does that work when that happens?

That obviously depends on a finding at SEC, I take it, that there has been—these costs were—let's go back to the case, I mean, if the SEC were to determine that they were actually inappropriate costs under the contract, but they are just looking at the contract, as I understand it.

Ms. MOLER. As I understand the answer, they reallocate the costs, but they do not review the basic costs at issue from a rate perspective. They will divide them up among the different parties, among the different members of the holding company, send them to Ohio instead of to Indiana, but they do not go into what we do day in, day out, and that is, we do rates. We investigate the prudence and justness and reasonableness of the rates charged by public utilities.

We are at this time foreclosed from doing that where there are public utility holding companies involved where the corporate structure has been approved by the SEC. They, to my knowledge, never looked at the actual rates charged by that coal company.

They simply looked at the corporate structure and approved the capitalization of the coal company. They did not look at what price was the transfer price among the subsidiaries.

We had an ongoing rate case and have had several that we have had to determine are moot in light of the Ohio Power decision.

Mr. SHARP. Mr. Roberts, do you folks at the SEC differ with Ms. Moler on that opinion as to whether—what the SEC would have looked at that point?

Mr. ROBERTS. I agree——

Mr. SHARP. I am not personally interested in the oversight of the specific cases.

Mr. ROBERTS. I would agree generally with Chairperson Moler's statement. The Commission does not regulate rates. That is not our mandate under PUHCA. That obviously is the FERC's mandate under the Federal Power Act. That was the division of responsibilities that Congress mandated in 1935.

We do look principally at the corporate financial structure and the financial relationship between the holding company and the affiliates, as well as the financial transactions between those parties, from a corporate financial perspective.

Mr. SHARP. In other words, to see that the investor is protected in that process and that the finances are correct and above board, is that——

Mr. ROBERTS. Well, that is part of our mandate. Our mandate includes, in terms of protected parties, investors, consumers, and the general public interest. This is contained in section 1 of PUHCA.

Mr. SHARP. But you have no way, if it turns out that other utilities, and even this utility—the hypothetical case that it is changing coal contracts with somebody that is a non-affiliate, in which you have no way to get at the question as to why it would not be changing coal contracts if others throughout the system are changing coal contracts, and even if the possibility is that the utility in question is changing coal contracts with suppliers, but does not change

it with its own affiliate, that is not—is that a question that you get at, get asked, would have to deal with?

Mr. ROBERTS. Well, we could get at it, I believe.

Would you agree, Bill?

Mr. WEEDEN. If there is an existing order authorizing affiliate transaction between a company and a coal mine, an affiliate coal mine, any change, subsequent changes are considered amendments to that application.

They would come back and file it with us for approval. We did look at the contract——

Mr. SHARP. Looked at the contract initially, right?

Mr. WEEDEN. Yes, sir.

Mr. ROBERTS. We could. That is my opinion, and I suspect we do on occasion. Again, there are resource limitations.

Mr. SHARP. But part of this court case, anybody who is concerned about this kind of transaction, it is unlikely they would have come to you once that approval had occurred. They would have gone to FERC, and they did go to FERC.

Mr. ROBERTS. Yes.

Mr. SHARP. And they say that, look, others in this business and this world are making adjustments because the coal market isn't what it used to be.

Why is this contract not being adjusted? I mean, that is what happens and that is not something you people would initiate——

Mr. ROBERTS. But we assumed erroneously that it would have been adjusted through the FERC's ratemaking procedures. We were as surprised as anyone by the Ohio Power decision. Now 10 years have passed, and we think it is high time that we change our standard so that it is more consistent with the FERC's standard on pricing.

Mr. SHARP. So in other words, you are saying that clearly if you do not change and you do not aggressively pursue what FERC would normally have been asked to pursue, then would you agree there is a gap here in terms of protection?

Mr. ROBERTS. Yes. We have serious concerns about the Ohio Power decision on the ability of FERC and the States to carry out their traditional ratemaking responsibilities.

We cannot change the Ohio Power decision. We can do some things administratively. I am pledging to you today that we are going to begin work to do so. We are going to work with FERC and the States in fashioning a rule in an attempt to address as many of the Ohio Power concerns as possible administratively.

Two years have passed since the Ohio Power decision. There has been no change. We want to change our standard.

Mr. SHARP. Well, that is obviously extremely important. I would suggest for the folks that don't want duplicative regulation, that that may be a course, if the system pushes it as you are suggesting it needs to be pushed, in that direction, that then there will, of necessity, have to become a different kind of regulatory body at the SEC in order to—and so that now some transactions will be covered in rate cases at the SEC or something akin to a rate case, and some transactions will be covered at FERC. It strikes me that you can have a new generation of problems here.

Go ahead.

Mr. ROBERTS. Well, this duplication exists already. That was the setup that Congress enacted in 1935. There exists regulatory overlap in certain areas. Chairperson Moler identifies some of those areas in her testimony.

The SEC did not design the system.

Mr. SHARP. I am not trying to accuse you.

Mr. ROBERTS. We do look at interaffiliate transactions from different perspectives. There is some inefficiencies in the current regulatory setup. It has not changed much in 50 years. I do not know how likely it is to change in the future.

Mr. SHARP. Well, one of our experiences, we just made some very significant changes which the registereds by and large were very pleased to have us make in PUHCA, and we want to make sure that we do not have, in conjunction with court cases, an area in which interaffiliate transactions can, in fact, protect a corporate decision against both the marketplace and the regulation.

Mr. ROBERTS. I agree.

Mr. SHARP. Mr. Gillmor is recognized.

Mr. GILLMOR. Thank you, Mr. Chairman.

This is a question for FERC and the SEC, and I am wondering, couldn't SEC and FERC reach some kind of Memorandum of Understanding or couldn't SEC change its regs so that FERC would be specifically notified any time SEC is asked to approve an interaffiliate transaction like this one?

Mr. ROBERTS. Is that directed to me, Congressman Gillmor? We certainly will look at those possibilities during our rulemaking proceeding and we will consult with FERC on those matters.

It is difficult to predict exactly what will happen from the rulemaking initiative. Obviously it is subject to the notice and comment process, as well as other various factors, but certainly your suggestions are generally sound.

Mr. GILLMOR. Do you see any disadvantage at first blush?

Mr. ROBERTS. Well, there are always mechanical problems as to how agencies can best interact together. SEC and FERC have worked together closely, it is my understanding, for, what, almost 60 years now. There is no reason why we cannot continue to.

We certainly were not opposed to the FERC position insofar as Ohio Power was concerned. We were as surprised by the decision as anyone. We assumed that the FERC would win the case. Unfortunately, that did not happen.

Mr. GILLMOR. Let me ask you, under the regulations, SEC regulations, do they specifically require that the State PUC's be notified and would it be helpful if that were the case?

Mr. ROBERTS. I do not know if there is an official notification requirement, but it is my understanding that they are notified, as a matter of course, and I would certainly be inclined to take into consideration your suggestions regarding official notification.

I would be surprised and disappointed if FERC was not notified, whether it was official or unofficial.

Mr. GILLMOR. Earlier you had said that one of the problems here was staff, and I think that there were 20 people.

Mr. ROBERTS. About twenty professionals, that is correct. We have asked for additional staff in this area as a part of the budget and appropriation process.

Mr. GILLMOR. And that really leads into my question, which was, to do the job right as opposed to the 20 professionals you have now, what in your opinion would it take?

Mr. ROBERTS. You mean in terms of our budget authority?

Mr. GILLMOR. Personnel, yes.

Mr. ROBERTS. As a result of the additional responsibilities that the Commission has acquired through the Energy Policy Act of 1992, we have requested almost to double our professional staff in the public utility regulation area over the course of fiscal years 1995 and 1996.

Now, this is only to fulfill adequately the additional responsibilities as a result of that legislation.

The SEC does intend to continue to work and rely on the fine work of FERC and the States in this area too, and to utilize their resources, within the mandate of PUHCA.

Mr. SHARP. If the gentleman would just yield 1 second, I am just curious, am I correct that SEC, like FERC, uses the user fee system to fund its work?

Mr. ROBERTS. We have asked for authority in that area in the past. This is one of the recommendations that may result from the study, however, Chairman Sharp.

This is an excellent point, and one that we will pursue.

Mr. SHARP. Well, this goes back on a bipartisan basis. We established that at FERC and in several of the other energy regulatory agencies. SEC doesn't come under the jurisdiction of the subcommittee.

Mr. ROBERTS. I will give you my own personal views. I would like to establish self-funding at the SEC as well.

Mr. SHARP. I appreciate that. Excuse me.

Mr. GILLMOR. Thank you, Mr. Chairman, and a question for FERC.

The Ohio Power decision says that a contract approved by SEC is conclusively just and reasonable for FERC's purposes, but it is my understanding that is because FERC itself had regulations stating that, and I understand FERC has changed its regulations so that the conclusive presumption is now only a rebuttable presumption, and my question is, how has that change in regulations worked in practice?

Ms. MOLER. That change in regulation does not work in practice for members of the registered public utility holding companies. There was a second D.C. Circuit decision in Ohio Power. Ultimately, the Ohio Power decision did go off on a technicality having to do with that presumption.

We intended to make it a rebuttable presumption, not something that could not possibly be overcome, which is the way the D.C. Circuit decision worked out. But right now we cannot overcome the presumption for subsidiaries of the registereds. So it doesn't work.

Mr. GILLMOR. Thank you. And one more question if I might, Mr. Chairman. SEC can deviate from at cost under 13(b) where there are, "special or unusual circumstances," and I am wondering if you could give some examples of those kinds of circumstances, and, for example, what about a coal company that might not be running efficiently? Would that fall within that pattern?

Mr. ROBERTS. Well, of course, engaging in hypotheticals is a dangerous game. Since it is a dangerous game, I will request that Bill respond to your question.

Mr. WEEDEN. Oddly enough, we would not be here had we relied upon Rule 92 in 1971. Rule 92 provides that goods produced by one affiliate and sold to another is done at the lower of cost or market, and that would have applied with your coal mine, but that was my first year there, 1971. I remember the meeting and basically what the problem was, that the company, AEP, Ohio Power, the subsidiary, needed assurance in order to meet the energy crisis and the reliable supply of coal, et cetera, et cetera. They couldn't sink $100, $200 million into this, and then hope that the market price would stay high enough so that they could get their money back, as well as a return.

So they asked for an exception from the rule 92 standard of lower cost or market and to do it at cost.

So the answer is normally things are done pursuant to Rule 92.

Mr. GILLMOR. Thank you.

Thank you, Mr. Chairman.

Mr. SHARP. The gentleman from Virginia, Mr. Boucher is recognized.

Mr. BOUCHER. Thank you very much, Mr. Chairman.

Ms. Moler, Mr. Roberts, let me just get you to respond and give you this opportunity to make comments with regard to some of the recommendations that Mr. Draper is going to make when he testifies somewhat later this morning.

He will recommend, first of all, that whenever the test for determining the pass-through is comparable market price, that that apply only to goods and not to services because services are somewhat more difficult to value in terms of comparable market price.

Do you believe he is right in suggesting that, or do you have a different view?

Ms. Moler.

Ms. MOLER. As I said in answer to a question from Chairman Sharp earlier, I would respectfully disagree with that. We are capable, through rate cases, of evaluating such things.

Mr. BOUCHER. So you think there is no problem in valuing services?

Ms. MOLER. No, sir.

Mr. BOUCHER. Mr. Roberts.

Mr. ROBERTS. I do not see any reason why the same general standard cannot be the same. It is more difficult to value services than goods. The determination is more difficult.

I do not know that this difference necessitates any change in the general standard to be applied.

Mr. BOUCHER. So you could apply a standard of comparable market price effectively to services as well as goods and both of you would agree with that?

Mr. ROBERTS. Well, the determination for services, market value of services is a more difficult determination.

Mr. BOUCHER. But you could do it effectively?

Mr. ROBERTS. I think so.

Mr. BOUCHER. Another recommendation that people make is that when the test is comparable market price, that there be what

amounts to a preclearance procedure whereby the registered holding company can get regulatory approval in advance of entering into a contract or making an investment to make sure that whatever it invests is recoverable at some future time.

What is your response to that recommendation? Is it practical? Is it something that we should consider if we choose to draft legislation in response to Ohio Power?

Ms. Roberts? Mr. Roberts.

Mr. ROBERTS. Yes, I suppose. It certainly sounds attractive in concept.

I want to point out one problem with this, however. If you look at the Ohio Power circumstance in 1981 when the SEC made the decision that the contract between the holding company and the interaffiliate should be set at cost rather than at market value, everyone thought that decision was great and wonderful. Ten years later it did not look as good.

Thus preapproval 20 to 30 years down the road may not be all that great a concept.

Mr. BOUCHER. It basically, I would just like your view of this, it would seem to me that if you put it in place, it has the basic effect of negating the comparable price standard in any event because it basically says whatever your cost is and entered into the contract making the investment, you will be able to recover it.

So doesn't that necessarily drag you right back to a cost standard, even if you choose to have a comparable price standard in effect?

Mr. ROBERTS. I suppose I would agree with that as a general proposition, but my point is, over a long term, you do have changed circumstances. You should have the ability to go in and reevaluate the situation as time and your information and the market changes.

Mr. BOUCHER. Ms. Moler, do you have a response to this?

Ms. MOLER. There are changed circumstances in markets that we regulate all the time. We have certainly witnessed that in the natural gas industry where contracts entered into in the 1980's are still with us and they are way above market.

We investigate contracts that are entered into on an after the fact basis under the Federal Power Act to determine whether they are still prudent contracts.

If we determine that they are not, then certainly utilities are capable of restructuring these contracts and we, as I mentioned earlier, do allow the pass-through of costs for buying them out.

We do not presently apply the market standard for services. I don't think that is the issue in this instance. Even under the Ohio Power case—even under a cost standard—Ohio Power precludes us from reviewing the prudently incurred just and reasonable costs of those services. But other utilities that are not members of the registered holding companies are subject to continuing regulatory oversight and scrutiny of their transactions, and it does not threaten their very existence.

They accept it and they know that they are subject to that sort of thing on both the Federal and the State level.

Mr. BOUCHER. OK. Your general comments with regard to a preclearance possibility, do you think that that is something we should consider or do you see problems in doing that?

Ms. MOLER. There are lots of States that have gone to a preclearance standard. The difficulty of course is a change in the market circumstance. We generally have not used a preclearance process at FERC, with the exception of pipeline construction, for example. We allow them to put the costs of constructing a pipe in rate base and they are allowed to continue to do that.

There are costs of nuclear power plants that are in rate base right now and in the changing marketplace, we are having to deal with the difficulty of when the electricity generated from those plants is no longer competitive. It is a very, very difficult issue.

Mr. BOUCHER. Would you agree that the practical effect of inserting a preclearance requirement to make sure that whatever the investment the utility makes in its project or in its—or commits to its contract could be recovered, doesn't that effectively insert a cost standard, even if you desire to apply a comparable market price standard? Because what you are effectively guaranteeing is that whatever they invest, they will get back.

Isn't that really by definition a cost standard, even in a regime where you are applying comparable market price?

Ms. MOLER. I think most utility lawyers would tell you that a utility is entitled to a reasonable opportunity to recover its prudently incurred costs. That is Black letter law in the utility business.

It does not mean, however, that regulators are precluded from determining whether those costs are prudently incurred or not. If they are not—if they have five people doing a job that one person can do, that makes no sense from a ratepayer point of view.

Mr. BOUCHER. So you could have that kind of determination made at the forefront to determine what is a reasonably incurred cost and still apply down the road a comparable market price standard; is that right?

Ms. MOLER. Yes, I believe so.

Mr. BOUCHER. OK. So your general comment then with regard to the preclearance possibility is that it is something we should consider and you don't see central problems with it, or do you see problems that should preclude any consideration of that?

Ms. MOLER. I have not thought a great deal about the preclearance standard. I would be happy to think about it and talk with people who know more about this than I do, and provide an answer for the hearing record.

Mr. BOUCHER. All right.

Ms. MOLER. But conceptually it is not difficult provided you do have the ability to look at prudence.

Mr. BOUCHER. If you could supply us some additional comments with regard to that, I think that would be very helpful.

Ms. MOLER. Yes, sir.

Mr. BOUCHER. The other recommendation which he makes, which I would like your response, is that what led to the Ohio Power litigation to begin with was a disparity in the treatment of the registered utilities on the one hand and the exempts on the

other, because the registereds had to comply with a SEC requirement.

The FERC was saying that comparable market price would be the test, and for the exempts that were subject to FERC regulation but not subject to regulation of the SEC, they therefore had the opportunity to recover an amount equal to comparable market price, whether that amount happened to be above or below their cost, and that was an opportunity denied to the registered utilities that were entitled to recover only their cost whether that amount was below market price or not. So they were getting the worst of both worlds in a sense.

Would you agree that whatever we do in terms of revising the Ohio Power standard not get us back into a regime where that kind of disparate regulation could occur with regards to registereds on the one hand, and exempts on the other?

Ms. MOLER. Since my plea is to treat them equally, then logic would dictate that I would agree with that. If the Ohio Power legislation were enacted, I believe that our regulations would have to change to have not just a one-way street that is a dead end, so to speak, for the registered subsidiaries.

Mr. BOUCHER. Mr. Roberts, do you have any comment with regard to that question?

Mr. ROBERTS. Well, one of the objectives of the rulemaking that I mentioned earlier that the SEC would embark upon in the not too distant future would be to achieve more consistency in terms of the standard that applies between registereds and exempts.

The standard will still not be entirely consistent, but it will be closer if the rulemaking works out as I envision.

Mr. BOUCHER. So you would agree that we, at the outside, should not create a circumstance where that kind of disparate regulation which I just described could occur?

Mr. ROBERTS. Yes. We need to minimize that as much as possible. Some disparities exist because you are dealing with two different statutes.

Mr. BOUCHER. But the kind of disparity that led to the litigation?

Mr. ROBERTS. Yes, no doubt. I generally agree with your point and that is one of the objectives that we are on a mission to accomplish.

Mr. BOUCHER. Thank you very much, both of you. My time is expired.

Mr. SHARP. The gentleman from Massachusetts is recognized.

Mr. MARKEY. Thank you, Mr. Chairman.

Mr. Roberts, on page 7 of your prepared statement, you acknowledge that hindsight suggests that better communication between the two regulators at that time could have averted an unfortunate judicial decision.

It appears, however, that this regulatory dialogue of the deaf is still continuing.

You don't think that legislation is needed and that you can deal with the consequences of Ohio Power by administrative action. Chairman Moler's testimony says just the opposite.

Can you explain to us why you have such dramatically different views as to the best way to resolve this dialogue of the deaf that exists between the two agencies?

Mr. ROBERTS. We are not opposing the call for legislation. We have supported legislation in the past. Today I am not advocating either support for, or opposition to, legislation.

Mr. MARKEY. So do you support this bill?

Mr. ROBERTS. Which bill?

Mr. MARKEY. The legislation that is before us today, Mr. Boucher's bill.

You haven't introduced it yet. How does it sound to you so far? Could you work with this? Could you work with this concept?

Mr. ROBERTS. The SEC today is not advocating either support for or opposition to legislation. We are indicating that we wish to attempt to deal with the Ohio Power concerns administratively as quickly as possible.

Two years have passed since the Ohio Power decision. Nothing has taken place. We intend to change our standard.

Mr. MARKEY. OK, good. So we can expect a new era of glasnost then between the two agencies?

Mr. ROBERTS. It is my impression that the agencies already work together very well.

The Ohio Power decision was not a resolution that we supported, and as I indicated earlier, I suspect the SEC at that time was very surprised by the early decisions. I was certainly surprised in 1992 at the ultimate resolution.

Mr. MARKEY. So you guys are now committed to resolving this?

Mr. ROBERTS. The SEC is committed to undertake a rulemaking proceeding to attempt to resolve the Ohio Power concerns administratively.

We intend to consult and coordinate with the FERC in that rulemaking effort. That is the best we can do under the statute as it presently stands.

Mr. MARKEY. So are you involved or committed here? What is the situation? I mean, we are still in the preclearance stage here of this marriage, and we want to know what it is going to take to resolve the obstacles so that we can—listen, I appreciate it. OK. Try to get preclearance for an Irish Catholic and a Jewish psychiatrist to get married, OK? So I can understand.

But it can be done, OK, and I am seeing the same kind of historic——

Mr. ROBERTS. The preclearance concept makes a great deal of sense.

Mr. MARKEY. OK, good. That is great. Chairman Moler, Commissioner Roberts has just testified that the SEC is prepared to move from a cost-base standard to a lowering of—to a market on a cost standard by changing its rules administratively.

Does this resolve the regulatory black hole you identified in your testimony which limits FERC's ability to review the costs of goods and services?

Ms. MOLER. No, sir.

Mr. MARKEY. What is the problem?

Ms. MOLER. We would still have no ability to review the rate consequences of any transaction that the SEC approved. We certainly desire to work with them.

It is not a question of animus between the regulatory commissions. It is a fundamental statutory problem.

Mr. MARKEY. OK. Is it resolvable?

Ms. MOLER. It is resolvable in my opinion by legislation. It is not in my opinion resolvable administratively.

Mr. MARKEY. Mr. Roberts, I believe section 13 of PUHCA serves a very important purpose, but a very limited one. The SEC determines whether utility funds should be spent to capitalize an affiliate and whether that affiliate can provide a good or a service that improves the efficiency and economy of the holding company system.

Do you share this view of your role?

Mr. ROBERTS. Yes, that is the standard that we are obligated to follow under the statute. If I was redrafting the act, would I consider a different standing?

I suppose I would, and that will be one of the matters under consideration with respect to the study that I mentioned earlier.

Mr. MARKEY. So you have not seen—the SEC has not seen its role as conducting least-cost planning or prudence reviews for regulated utilities historically?

Mr. ROBERTS. Our standard is not just and reasonable, if that is your point. That is a standard that exists under the Federal Power Act, not PUHCA.

Mr. MARKEY. Mr. Roberts, again, Chairman Moler's testimony states on page 9 and 10 that the SEC does not undertake rate hearings and does not appear to have the resources or procedural mechanism for handling complaints regarding affiliated transactions.

Chairman Moler also says that, "The SEC has no authority to order refunds if it determines that it should investigate and possibly lower the payments under an associate service or a construction contract."

Do you agree or disagree with that?

Mr. ROBERTS. We do not regulate rates, wholesale or retail. That is the regulatory function of the FERC and the States respectively. We can undertake to have hearings. We have had a few, not very many. It is a resource problem with us.

Mr. MARKEY. Do we still need legislation to make the change you are proposing to make as your new standard?

Mr. ROBERTS. For us to accomplish that administratively, no. For us to change our standard, legislation will not be necessary.

Mr. MARKEY. Will not be necessary. You agree with that, Ms. Moler? They don't have to change—we don't need a statute for that.

Ms. MOLER. For them to change their standard, I believe that is correct. But that still doesn't put us back in the rate business for subsidiaries at registered companies.

Mr. MARKEY. Mr. Roberts, as you know, a holding company might decide to set up a subsidiary to decommission a nuclear power plant.

Assuming that as a result of Ohio Power, you had preclusive authority to determine the reasonableness of the costs associated with this affiliate enterprise, what steps would you take to exercise this responsibility and what resources will you have or need in order to accomplish that goal?

Mr. ROBERTS. I am not sure that I understand your question.

Mr. MARKEY. What would be the standard that you would use if there was a decommissioning and you played a role in it? What would you——

Mr. ROBERTS. The standard is the same and that is 13(b), which is economic and efficient, as you just mentioned earlier.

But obviously we would change the pricing part of the transaction from a cost standard to a lower of market value or cost standard.

Mr. MARKEY. Let me ask you this: As you know, there are approximately 113, 115 nuclear power plants in the United States. There have been no new nuclear power plants ordered and constructed since 1974.

We are now entering a phase where the 110 or 115 which are on line are now 15, 20, 25, 30 years old and heading towards that 40-year period where people believe the life expectancy of most nuclear power plants are.

So it is going to become an increasingly major issue as nuclear power is phased out in this country. How are you going to handle it? Do you have the resources at the SEC to handle that issue?

Mr. ROBERTS. No, we do not. We do work very closely, it is my understanding, with both the NRC and the FERC with respect to nuclear matters.

We do not have the resources to deal with those problems by ourselves.

Mr. MARKEY. OK, thank you. In your—I just have another. In your prepared testimony, you indicated that the SEC——

Mr. SHARP. I am wondering if Mr. Weeden could comment on the question because I think he had something more specific.

Mr. WEEDEN. I could just sort of walk you through the nuts and bolts of how that would, not to use a pun, about the decommissioning, but we haven't had one of those and the way we would approach it is, a company would drop a subsidiary and want to transfer the assets into that subsidiary.

That would be a jurisdictional matter under sections 9 and 10, 12, and 13.

I would immediately get on the horn with NRC, FERC, and the relevant States and sit down and figure out how we are supposed to transfer this asset. Just because the act says at cost, there is still flexibility in there to provide that this be done at something other than cost.

Ms. MOLER. Mr. Markey, may I comment on that scenario?

Mr. MARKEY. Yes, please.

Ms. MOLER. We are currently adjudicating the prudence of decommissioning of a nuclear power plant. We do this now. A company filed rates to recover costs of decommissioning a nuclear power plant early.

We set those rates for hearing before an administrative law judge. We have hearings all the time. The administrative law judge has issued an initial decision and the decision is before the Commission right now to review the prudence of those rates.

This is precisely the kind of ratemaking issue that we are set up to do. It is not, however, done through a separate service company, as you postulate now. If that had been the case, the Ohio Power

decision would clearly call into question whether we could do what we are doing now regarding Yankee Atomic.

Mr. MARKEY. So the question is—and this is a Massachusetts question—shouldn't the FERC be doing this?

Mr. WEEDEN. My point is we don't get involved—we would not be involved in the rates. I am merely telling you how, if a company came to us and wanted to transfer the assets to a separate company for the purpose of doing this, it would be——

Mr. SHARP. Would the gentleman yield?

Mr. MARKEY. Sure.

Mr. SHARP. If—let's postulate that the FERC has completed its case that it has before it, and therefore has made—set some precedents as to what the policy would be that one might expect to be applied in other cases, and a registered with nuclear assets decides, gee, we don't like the way that came out, let's see if we have a second option here.

Doesn't this give them a second option that is not had by other utility companies, unless—I don't know if all nuclears are in registereds, but I suspect not, and therefore we will try the affiliate transaction and see if we can get a better deal on the costs from the SEC?

Now, maybe you won't give it to them; I don't know. Maybe you will follow the precedent set by FERC, but it strikes me that that opens up a second avenue of possibilities.

Am I incorrect about that?

Mr. ROBERTS. No. Chairman Sharp, I think in general, you are right. Any time you have two statutes that overlap in certain areas, the possibility for regulatory arbitrage exists.

The SEC in the past has strived to avoid that situation. Unfortunately, a dual regulatory regimen is the statutory makeup at the moment.

I would like to point out, back to the nuclear situation, there is an analogy in existence, I suppose. You can look at some of the mergers which have taken place recently, which are very large, and very complex. The SEC has relied on the FERC's hearing record when making determinations with respect to those mergers. I suspect that can be a model that can be used in the nuclear decommissioning situation Chairman Markey alluded to.

We want the FERC involved in these matters. We intend to continue to work with them as well as with the States.

Mr. MARKEY. If I could—let me just ask another quick couple questions.

One, in your statement you say that the SEC is going to do a review of PUHCA——

Mr. ROBERTS. Yes.

Mr. MARKEY [continuing]. With regard to modernization of it. As you know, during the Reagan administration, their idea of modernization was to repeal PUHCA, and I was just wondering if that might have been an approach that you had under consideration.

Mr. ROBERTS. It will be one of the alternatives under consideration. As you know, the SEC, over the course of 20 years, has at various times supported repeal. I am not today advocating repeal. That will only be one of the options under consideration.

At the other end of the spectrum, one of the alternatives under consideration would be to attempt to acquire additional resources so that the SEC can meet its responsibilities under PUHCA more effectively than it is currently.

Mr. MARKEY. We are trying, as you know, to help to get the SEC self-funding, to get you more resources, and that is our full intention, and we will achieve that, but even if we don't, I would just say that I don't think that a recommendation to repeal PUHCA would be well received.

Mr. ROBERTS. I understand that historically has been the case for 20 years.

Mr. MARKEY. That is a little like Pinocchio and Gepetto, but the bottom line is that it would not be well received.

Mr. ROBERTS. I am not advocating repeal today.

Mr. MARKEY. And I have one final set, which is that you said that it is sometimes more difficult to value services than products.

Do you think that the—that there should be sufficient reason to grandfather service contracts?

Mr. ROBERTS. Sometimes in order to avoid protracted litigation, it is better to apply things prospectively.

Anything retroactive is an invitation to litigation. No one wants to go through, again, Ohio Power III, another decade of litigation, but grandfathering appears to be a mechanism that you always end up dealing with in some form or fashion.

Prospective applications, on the one hand, is cleaner. On the other hand, it is fairly simple to apply one standard to all situations, even existing situations, but you may face litigation challenges in doing so.

Mr. MARKEY. And Chairman Moler, this is my final question, what do you think?

Is there any basis for immunizing as yet unrecovered past costs or unrecovered but unreviewed costs from regulatory review, provided they are service contracts, not products?

Ms. MOLER. I am an advocate of drawing the grandfather clause as narrowly as possible. My prepared statement on page 17 deals with this issue.

I would limit it to fuel related costs which were of course precisely what were dealt with in Ohio Power, and not services.

Mr. MARKEY. It just seems to me that if it is possible for the Securities and Exchange Commission to be able to value exotic butterfly straddled derivatives with quantitatively developed mathematical models, then it should be possible for us to value service contracts, and perhaps, you know, we can figure out some way here of insuring that all this stuff is done in a way that protects all the parties concerned.

Thank you.

Mr. SHARP. I thank the gentleman.

The Chair appreciates your time and attention to this matter and if we proceed, of course, we will need to have further conversations with the staff and the Commissioners of both commissions.

We certainly appreciate your attention to this today. Thank you very much for being with us.

The subcommittee will take a 5-minute break as they set up for our next panel of witnesses.

[Brief recess]

Mr. SHARP. We are very pleased to welcome our next panel of witnesses, Mr. Dr. E. Linn Draper, chairman of the board and chief executive officer of the American Electric Power Company; the Honorable Craig A. Glazer, chairman of the Ohio Public Utilities Commission; Mr. Charles Patrizia of Paul, Hastings, Janovsky and Walker; and Mr. Marty Kanner, coalition coordinator for the Coalition for PUHCA.

Gentlemen, I think you are probably familiar with our process. We will be happy to make any written materials you have a part of our published record and would appreciate your oral summary.

Dr. Draper, we welcome you here, are delighted to have you, and I must say, I don't know if this panel can follow the last act. We have never had so much humor around PUHCA. Most people would not put that on Jay Leno's list, but we somehow managed to do it, but Dr. Draper, we are very pleased to have you with us and happy to recognize you at this point.

**STATEMENTS OF E. LINN DRAPER, JR., CHAIRMAN, AMERICAN ELECTRIC POWER CO., AND ON BEHALF OF OHIO POWER CO.; CRAIG A. GLAZER, CHAIRMAN, PUBLIC UTILITIES COMMISSION OF OHIO, ON BEHALF OF NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS; CHARLES A. PATRIZIA, ATTORNEY, ON BEHALF OF AD HOC GROUP OF REGISTERED UTILITY HOLDING COMPANIES; AND MARTY KANNER, COALITION COORDINATOR, COALITION FOR PUHCA**

Mr. DRAPER. Thank you. You have issued a formidable challenge. I am Linn Draper, Chairman and CEO of American Electric Power.

AEP, as you know, is a registered holding company under the Public Utility Holding Company Act of 1935. We provide electric service to customers in seven States.

Ohio Power Company, and it is a company as well as a case, is one of the subsidiaries of American Electric Power, and my testimony is on behalf of both AEP and Ohio Power.

The litigation which resulted in the Ohio Power decision was both complex and protracted. I am a businessman, an engineer, and not a lawyer. Furthermore, I have been with AEP a relatively short period of time, about 2 years. I became the chief executive officer about a year ago, and there are doubtless people both on the panel and in the room that have more detailed knowledge of the company's activities than I.

If there are questions that I do not know the answer to, I will attempt to provide them expeditiously.

I am pleased to have the opportunity to present the Ohio Power Company side of the story in layman's terms, focusing on the history, the business considerations and the equities and inequities involved. We have had captive coal mines on the AEP system for a very long time. In fact, in 1918, the first mine mouth coal plant in the United States was developed at the Windsor Mine in West Virginia. We believe that vertically operated activities of our corporation have been beneficial to the ratepayers in the seven States in which we serve.

Mines have been added to the system over time in the 1940's and 1950's, and finally during the 1970's, there were substantial additions to our coal operations. We added these coal operations primarily in an attempt to assure a predictable supply of coal at a reasonable cost.

The coal prices during that period in the early 1970's were rising. We recognize that some of our unaffiliated suppliers were diverting coal that was dedicated to us by contract to others who were willing to pay a higher price for it and litigation ensued, but obviously you can't generate electric power with litigation.

Since there was no substitute for the coal and since we had an overriding responsibility to maintain reliability of our power system, we opened more of our own mines. We thought that was the way to insure continuity of supply at reasonable cost.

A large part of this most recent expansion was done through the Southern Ohio Coal Company, a subsidiary of Ohio Power Company. As an affiliate of a registered holding company, Ohio Power was required to obtain SEC approval to capitalize the Southern Ohio coal mining operations, and in 1971, Ohio Power made application to the SEC for that necessary approval.

In reviewing the proposal, the SEC staff insisted that prices for the coal be sold by the Southern Ohio Coal Company to Ohio Power at cost, that is, as opposed to market.

The SEC issued an order in 1971 approving Ohio Power's application subject to the condition that the prices be based only on actual costs. The SEC issued three other orders in 1978, 1979 and 1980, all expressly including the at-cost condition and approving further capitalization of SOCCO by Ohio Power and other transactions between the two.

It was in reliance on the SEC's approvals and the requirement that the arrangement between Ohio Power and Southern Ohio Coal be at cost that our system invested hundreds of millions of dollars to develop its mines. The SEC's at-cost determination not only was consistent with its statutory mandate under PUHCA, but also was consistent with the longstanding rate treatment employed by FERC and its predecessor agency, the FPC.

During all those years, through almost five decades from 1935 until 1981, everything was fine. There were no problems, no trapped costs, no regulatory gaps between the FPC and the SEC. This long period of tranquility contributed to permit the recovery of prudently made and prudently implemented investments in affiliates.

The 46-year period was trouble free for one basic reason. Both the SEC and the FPC, later the FERC, were operating on the same wavelength. They applied the same standard to affiliate transactions, the at-cost standard. In 1981, 10 years after we capitalized Southern Ohio Coal in reliance upon the at cost standard, the FERC changed its rules. It reversed its course, discarded cost and enunciated for the first time a new comparable market rule under which prices charged by unaffiliated suppliers were to control.

FERC's 1981 generic change in the affiliate pricing policy took place not in a rulemaking proceeding, which would have given everyone with an interest notice and opportunity to be heard, but in

a rate case involving a single utility, Public Service of New Mexico, which had requested the change.

FERC then applied its New Mexico decision as a precedent to all electric utilities, including the registereds. This unique situation of the registered companies was not before and was never presented to FERC when it changed its longstanding recognition of the use of the at-cost standard.

I don't know this for a fact, but I doubt that it ever crossed FERC's collective mind that it was putting the registereds in a box. For the non-registereds, FERC's cost of market that they could recover market where the market was above or below cost. There was a symmetry to it, a simple fairness about it. It was a two-way street, but not for the registereds. The SEC requires that affiliate transactions be performed at cost, but from 1981 until the Ohio Power decision in 1992, FERC would only allow registereds to recover market price in their rates.

Thus, the FERC's New Mexico decision handcuffed the registered into a lower cost or market formula. The D.C. Circuit called this regulatory regimen trapped cost. Simply put, the FERC's market company works for exempt companies and stand-alone utilities, neither of which must obtain prior SEC approval for contracts, and neither of which is bound to at-cost requirements statutorily. Registered companies are bound by both those requirements. We cannot be treated for some purposes by FERC as if we were just like the others unless we are treated, in fact, that way for all purposes.

In recent months, we have heard it stated that the D.C. Circuit in Ohio Power drastically changed regulation as it had existed since 1935 and thereby created a troublesome regulatory gap. That, as I have tried to indicate, is not so. FERC's New Mexico decision is the true source of the problem. It gave rise to conflicting regulation and trapped costs for the registereds.

What the D.C. Circuit did in Ohio Power was to recognize and prevent the unfair application of New Mexico to the registered holding companies. In so doing, it did what courts do and declared the law as it has always been.

It wasn't long after New Mexico that the Ohio Power Company was squarely confronted with FERC's new market price standard when, in 1982, Ohio Power requested FERC approval to include in its wholesale rates the coal costs charged to it by Southern Ohio Coal and approved by the SEC. Adhering to its new standard, despite the unique and limiting circumstances of PUHCA, FERC ruled in 1987 that Ohio Power would not be allowed to pass through any costs of Southern Ohio Coal that exceeded a comparable market price and ordered Ohio Power to refund any amounts received from its customers over and above the market rate.

Ohio Power appealed to the D.C. Circuit which reversed FERC's decision. While the basis of that decision was later reversed by the U.S. Supreme Court, the court remanded the case back to the D.C. Circuit to determine whether FERC's order violated its own regulations and whether that order failed to establish a just and reasonable rate because it trapped costs previously approved by the SEC.

On remand, the D.C. Circuit ruled that FERC's order was invalid on both grounds. The Ohio Power decision simply returned the reg-

ulatory framework to the original arrangement envisioned by Congress when it enacted the Public Utility Holding Company Act.

As a businessman confronted with extraordinary changes arising from congressional directives in the Clean Air Act, Clean Water Act, the Energy Policy Act of 1992 and so forth, as well as a likely paradigm shift from a regulated industry to one with significant competitive segments, the issues involved in Ohio Power are, to be blunt, the last war, and Congress should not expend effort on that problem but should assist the industry in its efforts to adapt.

Over the next few years, we will see few, if any, new fuel supply contracts between affiliates. In our own case, for example, we have gradually been divesting ourselves of captive mining operations. In fact, Southern Ohio Coal's Martinka Mine in West Virginia, which was the mine involved in the Ohio Power litigation, was sold last year.

I would venture to say that by the year 2000, when Phase II requirements of the Clean Air Act go into effect, affiliated coal transactions within registered holding companies will likely have become a nonproblem for everyone concerned.

If nevertheless Congress feels impelled to change the present regulatory system, we would ask that three principles guide any legislation that would affect the Ohio Power decision.

First, the legislation should be truly prospective in nature; that is, it should grandfather investments already made and arrangements already entered into. For example, future coal deliveries from existing mining operations should be grandfathered. All existing arrangements were created in reliance on SEC standards.

The electric utility industry is one of the most capital intensive industries in the Nation. It is not reasonable nor equitable to change course and overturn regulatory policies upon which registered companies and their investors relied in committing hundreds of millions of dollars.

Second, any such legislation should affect only contracts for goods. It is no easy task to determine a comparable market price even for a commodity such as coal. This became apparent during the FERC phase of the Ohio Power case. It will be infinitely more difficult to apply that standard to the types of professional services that the registered companies provide to the utilities and their systems.

There are no truly comparable arrangements, and in stand-alone utilities, many of those services, accounting, public affairs, legal, et cetera, are provided internally as they are in many nonregulated companies. The centralization of those functions in a service company avoids the need for each operating company of the system to have its own small pool of professionals and talent in each of the necessary disciplines. It leads to greater economies and efficiencies and is, we believe, essential to our continued functioning as an integrated system. Comparable market price simply is not an appropriate standard for providing such services.

Finally, we ask that any legislation provide a mechanism whereby future affiliate investments or arrangements may obtain binding approval at the threshold, up front before the investment is made or the arrangement entered into. That binding approval would ensure that if the registered implements its program in an efficient

and prudent manner, it will recover its costs through the rates charged to its customers. To approve an investment which is prudently implemented and some years later in a rate case to deny its full recovery is, I submit, unacceptable regulation. I would like to think that most of us would agree with that.

Mr. Chairman, in your letter of May 18th, you requested that I respond to three specific questions. With respect to your second question, my response is that if the three guidelines that I have just described were adhered to in any legislation addressing Ohio Power, we would not oppose such legislation.

Your first question relating to the concept of trapped cost as enunciated by the courts in the Mississippi case and the Ohio Power case is a rather legal one. I would therefore defer to and adopt the response of this question set forth at pages 14 and 16 of Mr. Patrizia's prepared testimony. I would also adopt Mr. Patrizia's response to the chairman's third question relating to Pacific Power and Light, which appears at page 18 of his prepared testimony.

I would add, however, that AEP is prevented from restructuring itself under—along the lines of Pacific Power and Light—and thereby avoiding SEC regulation under PUHCA because at least two and possibly three of the States in which the AEP system companies operate require that public utilities be domestically incorporated.

I thank the committee for its attention and would be pleased to respond to any questions.

Mr. SHARP. Thank you very much, Dr. Draper.

[Testimony resumes on p. 80.]

[The prepared statement of Mr. Draper follows:]

Testimony of E. Linn Draper, Jr.

Before the Energy and Power Subcommittee
of the House Energy and Commerce Committee

May 26, 1994

Good morning. My name is E. Linn Draper, Jr. I am Chairman and CEO of American Electric Power Company (AEP) and its subsidiaries. AEP is a registered holding company under the Public Utility Holding Company Act of 1935 (PUHCA) that provides electric service to customers in seven states. Ohio Power Company, the utility that was involved in the litigation that is the subject of this hearing, is one of AEP's subsidiaries. My testimony is on behalf of AEP and Ohio Power.

The litigation which resulted in the Ohio Power decision was both complex and protracted: six years before FERC, twice before the D. C. Circuit and twice up to the United States Supreme Court. Mr. Chairman, I am a businessman and an engineer, not a lawyer. Furthermore, I am relatively new to AEP, having joined it in March of 1992 and having become its CEO last year. While I have studied the Ohio Power case in some detail, there may be questions that I cannot readily answer. If I don't have the information at my fingertips, I will undertake promptly to obtain it for you. There are others on the panel who are better equipped to handle questions of a legal nature.

I am pleased to be here this morning to take advantage of an opportunity that rarely comes our way -- that is, to present Ohio Power Company's side of the story in layman's language --

focusing upon the history, the business considerations and the equities and inequities involved. This is an important matter for American Electric Power and that is why I am here.

We have had captive coal mines on the AEP System for a very long time -- as long ago as 1918 when we developed the Windsor Mine in West Virginia, which was part of the first mine mouth electric generating operation in the U. S.. Vertically integrated operations made a great deal of sense for our customers, for reliability of power supply and for the development of our region, even then. Mines were added during the '40's and '50's. Finally, during the early 1970's we made further substantial additions to our coal operations. We did this primarily in an attempt to ensure security of supply. Coal prices during that period were rising and we recognized that some of our unaffiliated suppliers were diverting our contract coal to others who were willing to pay a higher price for it. Litigation ensued. But you can't generate electricity with litigation, even when it results in money damages. Since there was no substitute for the coal and since we had an overriding responsibility to maintain the reliability of power supply, we opened more of our own mines -- what better way, we thought, to ensure continuity of supply.

A large part of this most recent expansion was done through Southern Ohio Coal Company (SOCCO), a subsidiary of Ohio Power Company. As an affiliate of a registered holding company, Ohio

Power was required to obtain SEC approval to capitalize SOCCO's coal mining operations. In 1971, Ohio Power applied to the SEC for the necessary approval. In reviewing the proposal, SEC staff insisted that prices for the coal sold by SOCCO to Ohio Power be set "at cost" (that is, at SOCCO's own cost, and not "at market"). The SEC issued an order in 1971 approving Ohio Power's application, subject to the condition that SOCCO's prices be based only on "actual" costs. The SEC issued three other orders in 1978, 1979 and 1980, all expressly including the "at cost" condition, approving further capitalization of SOCCO by Ohio Power and other transactions between the two.

It was in reliance on the SEC's approvals and the requirement that the arrangement between Ohio Power and SOCCO be at cost that our system invested hundreds of millions of dollars to develop its mines. These costs, in turn, became part of Ohio Power's cost of providing electric service. The SEC's "at cost" determination not only was consistent with its statutory mandate under PUHCA, but was also consistent with the long-standing rate treatment employed by FERC and its predecessor agency, the Federal Power Commission (FPC). Also during all those years -- through almost five decades stretching from 1935 to 1981 -- everything was fine, there were no problems, no "trapped costs," no "regulatory gaps" between FPC and SEC. This long period of tranquility contributed to our confidence that regulation would

permit the recovery of prudently made and prudently implemented investments in affiliates.

This 46-year period was trouble-free for one basic reason -- both the SEC and the FPC, and later FERC, during all those years were operating on the same wave length. They applied the same standard to affiliate transactions: the "at cost" standard.

Then in 1981, ten years after we capitalized SOCCO in reliance upon the "at cost" standard, the FERC changed its rules. It reversed its course, discarded cost and enunciated for the first time, a new "comparable market" rule under which prices charged by unaffiliated suppliers were to control.

FERC's 1981 generic change in its affiliate pricing policy took place, not in a rulemaking proceeding which would have given everyone with an interest notice and an opportunity to be heard, but in a rate case involving a single utility: Public Service Company of New Mexico which had requested the change. FERC then applied its New Mexico decision as a precedent to all electric utilities, including the registereds. The unique situation of the registered companies was not before, and was never presented to, FERC when it changed its long-standing recognition and use of the "at cost" standard. I don't know this for a fact, but I doubt that it ever even crossed FERC's collective mind that it was putting the registereds in a box. For the non-registereds, FERC's switch from cost to market meant that they could recover market whether market was above or below cost. There was a

symmetry to it, a simple fairness about it. It was a two-way street. But not so for the registereds. The SEC requires that affiliate transactions be performed at cost, but from 1981 until the Ohio Power decision in 1992, FERC would only allow registereds to recover market price in their rates. Thus, the FERC's New Mexico decision handcuffed the registereds to a "lower-of-cost-or-market" formula. The D. C. Circuit called this regulatory regimen "trapped costs." We call it "heads you win, tails I lose" regulation -- a "one way street," "grossly unfair." I respectfully submit that no American citizen or corporation -- or, yes, even electric utility -- should be placed in a situation by his or her or its government in which one can only lose and never win.

Simply put, FERC's market standard works for exempt companies and stand alone utilities, neither of which must obtain prior SEC approval for contracts, and neither of which is bound to "at cost" requirements statutorily. Registered companies are bound by both of those requirements. We cannot be treated for some purposes by FERC as if we were just like the others, unless in fact we are treated that way for all purposes.

In recent months we have heard it stated numerous times that the D. C. Circuit in Ohio Power drastically changed regulation as it had existed since 1935 and, thereby, created a troublesome regulatory gap. That, as I have tried to indicate, is not so. FERC's New Mexico decision is the true source of the problem. It

gave rise to conflicting regulation and trapped costs for the registereds. What the D. C. Circuit did in Ohio Power was to recognize and prevent the unfair application of the New Mexico case to registered holding companies. In so doing, it did what courts do -- it declared what the law has always been.

It wasn't long after the New Mexico decision that Ohio Power Company was squarely confronted with FERC's new market price standard when, in 1982, Ohio Power requested FERC approval to include in its wholesale rates the coal costs charged to it by SOCCO and approved by the SEC.

Adhering to its new standard despite the unique and limiting circumstances of PUHCA, FERC ruled in 1987 that Ohio Power would not be allowed to pass through any costs of SOCCO coal that exceeded a "comparable market" price and ordered Ohio Power to refund any amounts received from its customers over and above the market rate.

Ohio Power appealed to the D. C. Circuit, which reversed FERC's decision. While the basis of that decision was later reversed by the U. S. Supreme Court, the Court remanded the case back to the D. C. Circuit to determine whether FERC's order violated its own regulations and whether that order failed to establish a just and reasonable rate because it "trapped" costs previously approved by the SEC. On remand, the D. C. Circuit ruled that FERC's order was invalid both because it violated its

own regulations and because it trapped costs previously approved by the SEC.

The Ohio Power decision simply returned the regulatory framework to the original arrangement envisioned by Congress when it enacted PUHCA. The SEC has jurisdiction over the corporate and contractual arrangements among affiliates within registered public utility holding company systems. While FERC and SEC jurisdiction might overlap in practical terms, the companies, investors and all other interested parties can rely on and are bound by an SEC decision when it is made. This provides much needed stability and consistency in an industry in which decisions may involve hundreds of millions of dollars of investment.

Moreover, as a businessman confronted with extraordinary changes arising from Congressional directives in the Clean Air Act, the Clean Water Act, the Energy Policy Act of 1992, etc., as well as a likely "paradigm shift" from a regulated industry to one with significant competitive segments, the issues involved in Ohio Power are, to be blunt, the last war, and Congress should not expend effort on that problem, but should assist the industry in its efforts to adapt. Over the next few years, we will see few, if any, new fuel supply contracts between affiliates. In our own case, for example, we have been gradually divesting ourselves of our captive mining operations. In fact, SOCCO's Martinka Mine in West Virginia, which was the mine involved in

the Ohio Power litigation, was sold last year. I would venture to say that by the year 2000, when the Phase II requirements of the Clean Air Act go into effect, affiliated coal transactions within registered holding company systems will likely have become a non-problem for everyone concerned.

If, nevertheless, the Congress feels impelled to change the present regulatory system, we would ask that three principles guide any legislation that would affect the Ohio Power decision. First, the legislation should be truly prospective in nature. That is, it should grandfather investments already made and arrangements already entered into. For example, future deliveries of coal from existing mining operations should be grandfathered. All existing arrangements were created in reliance on SEC standards, and investments, loans and other significant financial arrangements should not be undermined by subsequent new rules. FERC should not be allowed to adjust the SEC approved cost factor of those contracts in making rate decisions. The electric utility industry is one of the most capital intensive industries in the nation, and many of our decisions concerning investment -- such as deciding to build generating plants -- must be made many years in advance of the time they are needed. It is not reasonable or equitable to "change course" and overturn regulatory policies upon which registered companies and their investors relied in committing hundreds of millions of dollars.

Second, any such legislation should affect only contracts for goods. It is no easy task to determine a "comparable market price" even for a commodity such as coal. (This became apparent during the FERC phase of the Ohio Power case). It will be infinitely more difficult to apply that standard to the types of professional services that the registereds' service companies provide to the operating utilities of their systems. There are no truly comparable arrangements, and, in stand-alone utilities, many of those services -- accounting, public affairs, legal, etc. -- are provided internally as they are in many non-regulated companies. The centralization of those functions in a service company avoids the need for each operating company of the system to have its own little pool of professional talent in each of the necessary disciplines. It leads to greater economies and efficiencies and is, we believe, essential to our continued functioning as an integrated system. "Comparable market price" simply is not an appropriate standard to apply to such services.

Finally, we ask that any such legislation provide a mechanism whereby future affiliate investments or arrangements may obtain binding approval at the threshold, up-front before the investment is made or the arrangement entered into. That binding approval would ensure that if the registered implements its program in an efficient, prudent manner, it will recover its costs through the rates charged to its customers. To approve an investment which is prudently implemented and some years later in

a rate case to deny its full recovery is, I submit, unacceptable -- in fact, intolerable -- regulation. I like to think that most of us would agree with that.

Mr. Chairman, in your letter to me of May 18, you requested that I respond to three specific questions. With respect to your second question, my response is that if the three guidelines that I have just described were to be adhered to in any legislation addressing the Ohio Power case, we would not oppose such legislation.

Your first question relating to the concept of trapped costs as enunciated by the Courts in the Mississippi case and the Ohio Power case is quite legalistic in nature. I would, therefore, defer to and adopt the response to this question set forth at pages 14-16 of Mr. Patrizia's prepared testimony.

Also, I would adopt Mr. Patrizia's response to the Chairman's third question relating to Pacific Power & Light Company (PP&L) which appears at page 18 of his prepared testimony. However, I would add that AEP is prevented from restructuring itself along the lines of PP&L and thereby avoiding SEC regulation under PUHCA because at least two and possibly three of the states in which AEP System companies operate require that public utilities be domestically incorporated.

I thank the Committee for its attention, and would be pleased to respond to questions.

Mr. SHARP. We are now very pleased to hear from Mr. Glazer.

## STATEMENT OF CRAIG A. GLAZER

Mr. GLAZER. Mr. Chairman and members of the subcommittee, good morning. It still is morning, although just barely at this point. I am Chairman Greg Glazer of the Public Utilities Commission of Ohio and I am here this morning testifying on behalf of the National Association of Regulatory Utility Commissioners, known as NARUC, which represents the regulatory commissions which are responsible at the State level for regulating the rates and services of electric utilities in all 50 States of this Nation and in the District of Columbia.

NARUC greatly appreciates the opportunity to provide its views to the subcommittee on the need for legislation, and I think there really is a need for legislation to clarify the respective responsibilities of the SEC, the FERC and the State Commissions in light of this Ohio Power decision.

I do have to say that, you know, whenever you talk about this issue, and I suppose in this testimony and other's testimony we are going to get into all of these legal, legal technicalities and certainly the lawyers have done very well with the Ohio Power legislation—or litigation over the past 10 years, but I think we do have to keep in mind that there are real people out there that are affected by this decision.

As Chair Moler of the FERC said, 49 million households in this country will have their rates affected by the result of the D.C. decision in the Ohio Power case. So although this is something of a lawyer's delight to talk about these issues, there are some very real impacts of it.

In fact, we have on our State Commission, we have five commissioners. Four of us have a legal background, either former legislators or lawyers, and one of our commissioners is a geologist. And our geologist commissioner just recently came into my office clutching an article about a new ordinance he saw in a small town in Texas that said that all lawyers have to be buried 20 feet under the ground. The idea was that deep down, lawyers weren't such bad guys.

I do need to say, though, that I agree with the opening remarks of Congressman Gillmor from my home State that although we are talking about the name as Ohio Power, this, in fact, is a national issue and a national problem and I think it is appropriate then that we are here in Congress to discuss it.

And I also agree with the opening remark of Congressman Markey that the issue is going to get more difficult if this is not fixed, not less difficult. It is not going to go away. It is going to get more difficult, particularly since the registereds have expressed a strong interest in getting into the field of telecommunications. If we have problems with who polices affiliate transactions now when it is just within the scheme of providing electric service, imagine when the electric company is also in the phone business, all of these competing issues, and then you will have FCC, FERC, and SEC and the States and everybody pointing and using this Ohio Power decision to muddy the waters as to who is on first and who is on second and who does what.

The court decision in Ohio Power has truly created a regulatory gap that enables registered holding companies to avoid meaningful FERC review of costs associated with utility operations by potentially spinning off those costs to an affiliate who contracts with utility subsidiary, because there is the potential now to shop jurisdictions. Spin something off to an affiliate and then fall within the Ohio Power and sort of try your chances at the SEC if you couldn't get a favorable ruling from the FERC or the States.

While the decision only applied to FERC regulation of wholesale power sales, it clearly threatens State regulation of a far larger share of costs recovered in retail rates.

If you look at the relative revenues that the FERC is responsible for as opposed to what the States are responsible for, I would say that in many cases, the FERC basically controls 5, 10, 15 percent of a registered holding company's dollars and revenues, but the State is responsible and State ratepayers pay for 85 percent of those costs. So in many ways, the impact of this decision on the States has a very significant ripple effect that has really complicated matters even more.

Because under Ohio Power, from what the court told us, the SEC now is the only Agency at the Federal level that has the statutory authorization to determine what customers, what households in my State pay for electricity and unless Congress corrects that, we are going to have that continued problem. The problem really is not that the SEC—that there is some fault within the SEC, but that this is not within their statutory mission and I think you heard that this morning.

They don't look at whether rates are just and reasonable. They don't approve the transactions. They approve the financing of the affiliate suppliers. I have never seen an SEC auditor out in my State looking at comparable coal prices and coal costs and looking at going up and down the Ohio River to see what different suppliers provide. They don't have the time, nor is it within their statutory mission to do that.

The other critical point that the Commissioner from the SEC indicated or actually did not point out is that there is no process at the SEC to deal with these issues. We at State Commission commissions, the Federal Energy Commission, we hold hearings, we have auditors, we have hearings.

In our case, we go and hold local public hearings in the consumer territory. Consumer advocates can come in and present their cases. The SEC has 20 people to do this nationwide and does not have the adjudicatory process that the States and the FERC have had for many, many years.

In fact, I really stopped myself today when I heard that the SEC is going to embark upon this new notice of proposed rulemaking to look at what they should be doing in this area. My first question is: So why did it take 2 years? This decision has been around for 2 years. Why has it taken 2 years to announce this?

But second, I stopped myself and said, wait a minute, where are we going with this. This is going to create more duplication. The opponents of changing the Ohio Power rule argue that, well, it is just going to cause duplication. We literally are at the threshold of now the SEC proceeding to undertake and—a notice of proposed

rulemaking to look at what it should do with regard to how it is going to look at affiliate contracts and what auditors and it is coming here asking for a doubling of its staff, and I don't quarrel with that, but that is what FERC has a staff to do. That is what we have a staff to do. We are literally going to be creating a duplication here if Congress does not resolve this problem.

Now, the registered representatives would argue that changing the Ohio Power decision is unfair, and I think you heard that from Dr. Draper, someone who I have great respect for. The argument is that it is not reflective of how business should operate, but I think we have to step back and think about that for a minute, because really what the registereds are arguing to this Congress is that they should be allowed to pass through to captive ratepayers costs which are above market and are above competitive prices, and they are claiming that to do anything else is grossly unfair and is not what any government corporation should be allowed to do.

A member of my family is in the home appliance business which I can tell you is extremely competitive business. I am sure he would love to know that now he can suddenly pass through his costs and he doesn't have to worry about what his competition down the street is charging. That truly is not the American way. The American way is to have competition and to have market forces as opposed to a blanket pass-through of costs.

I am afraid that really what we have now available to us to the registereds is an ability to use, if not game the regulatory process to avoid that market scrutiny, which we do at the State level, which the Federal Energy Commission does at the Federal level.

Imagine, if you will, just a situation, if United Airlines suddenly decided to go into the jet fuel business and because of whatever decisions were made, their prices for jet fuel ran up double what any of their competitors were, and as a result, the ticket prices doubled and they began to lose market share and lose revenue, and then imagine that United Airlines, and maybe—perhaps they have done this I don't know, but they throw themselves on this Congress seeking regulatory protection for, a, "binding approval," to prevent the loss of revenues that they were experiencing.

I would trust that this Congress would not entertain such special relief saying, look, this is a competitive business. You went into this transaction, you took the risk, and in fact it would be unreasonable to shield you from market forces. We don't shield people from market forces.

Well, regulation was designed as a proxy for competition. It was not—and it was designed to mimic the forces of competition. And so regulation ought to be accomplishing the same result even though the utilities don't have the same level of competition that a United Airlines would have. But regulation cannot function if the regulators don't have the tools needed to drive competitive results.

Let me tell you a little bit about what the regulatory gap means in our State, and I think it is fitting to give you a real live example of this. In our State, we have a number of utilities. In fact, we have two holding companies, one registered with the SEC and one exempt. Their corporate offices are maybe 30 or 40 miles apart and their service territories actually abut each other so that on one side of the street, the ratepayer is a customer of AEP and on the other

side of the street they are the customer of the other company, which is not registered.

As Congressman Gillmor knows, there are multiple utilities that come together and he is very good about sending me all the constituent letters when people complain about, "How come my neighbor down the street is paying *X* or *Y* or *Z*?"

But under the traditional system before the Ohio Power case, the ratepayers on both sides of that street had the same protection. They had the protection of the State Commission in its role of protecting retail ratepayers, routinely reviewing the transactions from the purchase of pens and pencils to the purchase of management and legal services.

The State Commission in both cases applied market tests and disallowed costs when a competitively bid price would have resulted in lower cost to a regulated entity and its customers. And by the same token, the FERC did this at the Federal level.

Under the Ohio Power decision, now we have this anomaly. Ratepayers on the side of the street served by the registered holding company can't come to my Commission anymore and argue—their consumer representatives can't argue that cost is excessive. Our staff can't review those costs. Instead, we have to go to the SEC which has never held a hearing on these issues and as you heard today, is not equipped to deal with these issues. On the other hand, on the other side of the street, the customers of the exempt holding company still go through the process.

So I would argue if there is any disparity, it is a disparity right now in favor of the registereds, as a result of the anomalies of the Ohio Power decision, and that if you reverse that through legislation, you would be putting people back on a level playing field between the registereds and the exempt utility holding companies.

And I do have to beg to differ with Dr. Draper on this. He said that we have a situation where, well, gee, the non-registereds can charge market prices while the registereds are limited by the SEC to only charge cost. I can't speak for what happens at the Federal Energy Commission, but I can tell you in my commission, and in commissions around the States, the non-registereds, the exempt holding companies, can't charge market prices. It is cost of service regulation, and so they too are limited to the lower of cost or market.

I haven't heard them complain about that. They complain about a number of things but no one has complained about that. In fact, if we changed the rules, we would again be putting the registereds on a superior footing and I would suggest they are actually on a superior footing right now as a result of the Ohio Power decision.

I agree with Chair Moler, this is a fundamental problem. It is not a question that the agencies can get together and work this out. I think there is some good faith in the agencies to try to work this out, but it is a fundamental legal problem that I believe only this Congress can fix.

How would one go about doing this? We have on behalf of NARUC a couple of ideas. The first approach, which we have already drafted to accomplish—accommodate a different committee in the Senate, is to amend section 318 of the Federal Power Act, and Chair Moler suggested something along those lines also, to

preserve both FERC and State authority in reviewing nonpower interaffiliate transactions to allow the FERC and the States to continue to do their jobs.

The second approach is to amend section 13(b) to include a provision that restores FERC authority and State authority to provide the reasonableness of nonpower interaffiliate transactions.

A third approach would be to repeal the at-cost standard entirely in the Public Utility Holding Company Act, repeal section 13(b) of PUHCA, and this approach is really based on the fact that 13(b) and this cost standard as applied by the SEC is simply unworkable from a regulatory standpoint and creates the inherent conflict in jurisdictions between the SEC, FERC, and the States.

Does the at-cost standard under 13(b) put the SEC in a position of performing a function that it simply cannot do as a matter of policy or that it has the expertise or even the statutory mission to do. So that is a third option as to how one could do this.

Let me suggest a couple of things that we feel very strongly the legislation should not include. Previous drafts to Ohio Power legislation have included a deference standard for SEC decisions and unlimited grandfathering of existing contracts approved by the SEC. NARUC would oppose both of those proposals. For one, the deference standard simply does not respond to the very real problem we have here, namely, the need for expert review of the reasonableness of utility operations.

As Commissioner Roberts indicated, they just don't have the staff and the resources to do this, so for the States and the FERC to give deference to folks that really are admitting they don't have the resources doesn't make a lot of sense. If anything, if you are going to have deference, have deference going the other way, that the SEC would in fact give deference to FERC and the States and we heard Commissioner Roberts suggesting that as an alternative.

Second, and I think this really is very critical, a broad grandfathering of all existing contracts, regardless of the breadth of those contracts, the lawfulness of costs incurred to date or the bills still yet out there with regard to potential future costs I think would defeat much of the purpose of the legislation. The exception, the grandfathering exception would swallow the rule itself and the statute that you were trying to correct.

The registereds clearly expected both FERC and State regulatory review prior to the Ohio Power decision. And attached to my testimony is clear evidence that prior to Ohio Power, the States were reviewing these transactions. The registereds were not heard to complain about it. That was the status quo.

Back in my State, we have a statute on the books that gave the State Commission the authority to review affiliate transactions. That was passed. In fact, the SEC wrote in, it is attached to my testimony, they didn't have any objection to that statute. Clearly when all these dollars were invested, the registereds understood what the system was, and in fact it is no different than the system for the non-registereds.

I think that if anything, we might—it is appropriate to look at some grandfathering of those transactions that have taken place, but a grandfathering of existing contracts pulls in literally millions

and millions of dollars, pulls in cases, many of these contracts that go back for years and are sort of Evergreen contracts.

The contract is a service corporate agreement written maybe 15, 20 years ago and says all costs from the service company to the affiliate shall be passed through. If we grandfather that, then we are, in fact, worse off than we might be under the Ohio Power decision and Congress would have accomplished nothing in terms of fixing this problem.

I want to thank the chairman and the members of the subcommittee for the opportunity to comment on these very important issues. NARUC really does look forward to working with all interested parties in the weeks ahead and wishes to work with you to develop legislation that serves the interest of the Nation's 49 million consumers of electricity that are affected by this decision.

Thank you very much. Thank you.

[Testimony resumes on p. 98.]

[The prepared statement and attachments of Mr. Glazer follow:]

# TESTIMONY OF
# THE HONORABLE CRAIG A. GLAZER, CHAIRMAN
# PUBLIC UTILITIES COMMISSION OF OHIO
# ON BEHALF OF THE
# NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

Mr. Chairman and Members of the Subcommittee:

Good morning, I am Chairman Craig A. Glazer of the Public Utilities Commission of Ohio. I am here this morning testifying on behalf of the National Association of Regulatory Utility Commissioners (NARUC), which represents the regulatory commissions who are responsible for regulating the rates and services of electric utilities serving retail ratepayers in the 50 States and District of Columbia.

The NARUC greatly appreciates this opportunity to provide its views to the Subcommittee on the need for legislation to clarify the respective roles of the Securities and Exchange Commission (SEC), Federal Energy Regulatory Commission (FERC) and State commissions (PUCs) in light of the 1992 decision of the D.C. Circuit in Ohio Power Co. v. FERC, 954 F.2d 779 (1992).[1]

## Regulatory Problems Created by Ohio Power Decision

The court's decision in Ohio Power has created a regulatory gap that enables registered holding companies to avoid meaningful FERC review of costs associated with utility operations by placing those costs in an affiliate who contracts with operating utility subsidiaries. While the decision only applied to FERC regulation of wholesale power sales, it clearly threatens State regulation of a far larger share of costs recovered in retail rates. With FERC and State commissions precluded from reviewing the costs of affiliate contracts, the SEC will have exclusive but flawed authority to protect ratepayers. Despite its best intentions, the SEC is not a rate regulatory agency responsible for regulating the reasonableness of these necessary costs as a traditional economic regulatory body would. Yet, under Ohio Power, the SEC is the only agency at the Federal level that has the statutory authorization to do so--unless Congress corrects the D.C. Circuit's findings.

The problem is that under section 13(b) of the Public Utility Holding Company Act (PUHCA), the SEC does not regulate these transactions as a utility regulatory commission would, i.e. by determining whether a utility's acquisition of goods and services was reasonable and efficient in light of competitive suppliers in the market. Rather, as occurred in Ohio Power, the SEC approves the financing of the affiliate supplier upon its creation (and perhaps subsequent recapitalizations) with a condition that transfers of goods and services to affiliated utilities be conducted at the supplier's cost. The actual affiliate contracts do not come before the SEC for its approval, and accordingly, the SEC has no opportunity to determine whether the affiliate's costs are reasonable in and of themselves, let alone in comparison to arms-length transactions in the market.

---

[1] The NARUC Executive Committee adopted a resolution at its 1993 Winter Committee Meetings that supported Congressional action in this area. This resolution is attached to this statement.

The opportunities for unfair allocation of costs to the affiliate are obvious. But after Ohio Power, traditional regulation of these transactions of registered companies by FERC is over. Worse, from our perspective, further litigation may well result in preemption of State regulation at the retail level as well, meaning that there will be no effective oversight of the contracts a utility subsidiary signs with an affiliate initially, or the utility's implementation of a contract on an ongoing basis.

What the Regulatory Gap Means for PUCO

The present regulatory gap caused by the Ohio Power decision has suddenly put the role of both the Federal Energy Regulatory Commission and the States into serious question. Ironically, it has also put the registereds into a position which is superior to that available to other non-registered utility holding companies. For example, in my State we have at least two holding companies that operate within 40 miles of each other--one registered with the SEC and one not. The non-registered holding company goes through the traditional regulatory process--the State commission as part of its role of protecting retail ratepayers routinely reviews its transactions between the holding company and its affiliates, from the purchases of pens and pencils to the purchase of management and legal services. We have applied market tests and have disallowed costs in situations where a competitively bid price would have resulted in lower costs to the regulated entity and its customers. By the same token, purchase power transactions between the two affiliates are reviewed by FERC through rate proceedings and contract reviews. This system, although at times leading to some conflicts between the FERC and the States, has served us well for many years.

Until the Ohio Power decision, ratepayers in my State served by the operating company of a registered holding company had the same regulatory protection as their fellow ratepayers only 40 miles north. The system worked and no one from the registered holding companies were heard to complain. But now, under the Ohio Power decision, neither the FERC nor the States have this same ability to audit transactions and review costs of registered holding companies. Rather, the SEC, which has a statutory mission first and foremost to protect investors and which does not preside over rate cases let alone hold hearings, is the final arbiter of what should and should not pass through the fuel adjustment clause and what the citizens of my State should pay for much of their electric bill. This is indeed ironic since the SEC clearly does not have the accountability to the legislature and Governor of my State that I or my fellow Commissioners have.

This anomaly resulting from the Ohio Power decision has reduced the FERC and State commissions to mere automatons--being forced to pass-through, without question, huge costs which have not been the subject of detailed regulatory review when compared to

market prices and for which customers cannot question the company or challenge in a rate case hearing. The system is broken. Despite its best intentions, I would suggest that the SEC simply cannot, either as a matter of law under its statutory mission or as a practical matter, go into all 50 States in this nation and conduct the kind of detailed company reviews and hold local public hearings to hear the views of consumer advocates as we are required to do. For our system of Federalism to work, the FERC and the 50 State commissions should be allowed to do their job and not have a third super-agency, the SEC, dictating from Washington what consumers in America will pay.

In our opinion, the best solution is to enact legislation that does two things: **first**, restores FERC's authority to regulate the passthrough of affiliate contract costs in wholesale rates; and **second**, protects State authority from Ohio Power-like preemption at the retail level by explicitly affirming the right of State authorities to review such contract costs. Such legislation would simply restore the pre-Ohio Power jurisdictional status quo (at least as understood by the FERC, the SEC and State commissioners) by enabling the FERC and the States to perform their traditional regulatory function of assessing the reasonableness of all costs that go into wholesale and retail rates. Such legislation would take nothing away from the SEC, which would retain its authority to approve or disapprove financings necessary for the creation or further capitalization of an affiliate.

State coverage in this legislation is imperative. State regulatory commissions have traditionally and routinely regulated the passthrough of costs of transactions between utility subsidiaries of registered companies and their associate companies. In fact, in the attached memo to my statement, NARUC has identified 23 cases of State regulation of affiliate transactions beginning in 1973 and ending in 1990 (see attached memorandum).

"Trapped Costs" Argument Not Applicable in Ohio Power

"Trapped costs" as used in the context of the Ohio Power decision bears no resemblance to its application in the Mississippi Power & Light (MP&L) decision. These cases differ on significant factual grounds. In Ohio Power, there was no formal cost review by the SEC. The agency simply said Ohio Power could capitalize its affiliate and the affiliate could sell coal to Ohio Power. This was a non-power transaction. The MP&L decision, on the other hand, involved an FERC decision allocating power and costs from a nuclear power station among the utility subsidiaries of a registered system operating in four different States.

The most important factual distinction between the two cases is that in MP&L, the utility subsidiaries were compelled by the FERC order to take and pay for their respective shares of the costs and power at issue. Accordingly, the court found that a State

commission decision which refused to allow a utility subsidiary to recover these costs would result in impermissible "trapping." By contrast, in Ohio Power, the SEC order at issue did not compel any utility subsidiary to purchase coal from a subsidiary, as opposed to an unaffiliated supplier. Accordingly, no costs were "trapped" in the MP&L sense by the FERC's refusal to passthrough above-market coal prices.

Notwithstanding these important factual distinctions, and even though the court badly erred in applying the "trapped costs" argument in Ohio Power, the NARUC submits that extension of the Ohio Power ruling to the States will result in the pre-emption of State authority to review the reasonableness of non-power transactions of affiliates of registered systems. This situation clearly gives registered utility holding companies an advantage over exempt, stand-alone utilities operating in States that can review these transactions.

Legislative Approaches for Fixing the Ohio Power Decision

In our view, there are three possible legislative approaches the Subcommittee can take with respect to fixing the problems created by the Ohio Power decision.

The first approach--which we have helped draft to accommodate different committee jurisdictions in the Senate--is an amendment to Section 318 of the Federal Power Act to preserve both FERC and State authority in reviewing non-power, interaffiliate transactions of registered systems. This language would allow continued FERC and State review of the reasonableness of any costs associated with transactions subject to Section 12 and 13 of PUHCA. This language also would make clear that this language does not reduce any authority which FERC or the States already have in reviewing power transactions of public utilities.

A second approach is to amend Section 13(b) to include a provision that restores both FERC and State authority to review the reasonableness of non-power, interaffiliate transactions. A savings clause approach may be the most appropriate way to achieve this result.

A third approach would be to repeal Section 13(b) of PUHCA. This approach is based on the argument that Section 13(b) is unworkable from a regulatory standpoint and creates an inherent conflict between the jurisdictions of the SEC, FERC and impliedly the State commissions. The "at cost" standard under Section 13(b) puts the SEC in position of performing a function that it can not do from a policy or technical standpoint. The SEC lacks authority to review utility operations; it lacks the resources to investigate and regulate interaffiliate transactions; and it lacks regulatory tools necessary to protect consumers. Removing Section 13(b) would not disrupt the SEC's traditional role of reviewing the financial

underpinnings of transactions and would allow both the FERC and the States to apply their prudence standards in reviewing these transactions from the consumer viewpoint.

What Ohio Power Legislation Should Not Include

Previous drafts of legislation to fix Ohio Power have included a deference standard for SEC decisions and unlimited grandfathering of existing contracts approved by SEC. The NARUC would opposes both of these proposals being part of corrective legislation. The deference standard simply does not respond to the real problem Ohio Power created: the need for expert review of the reasonableness of utility-type operations. Moreover, if the legislation does not provide explicitly for a formal SEC review, the "deference" concept would not only be unwise but illogical. Interaffiliate contracts are required to conform to SEC regulations and are merely filed with the SEC. There is no formal review, hearing or approval. We do not understand how FERC or State commissions can "defer" to a decision never made. If a deference rule were to apply, it more logically should be allowed to go in the other direction--to the States and FERC.

Including a broad grandfathering of all existing contracts, regardless of the breath of the contracts, the prudence and lawfulness of costs incurred under them to date, and most importantly, the extent of costs not yet incurred, would defeat much of the purpose of legislation. Any legislation should distinguish legitimate expectations for the recovery of reasonable costs from the illegitimate expectations for the recovery of all costs, past and future, without regard to prudence. More than any other regulatory entity, States are charged with the responsibility to ensure prudent utility operations. Moreover, we are not aware of any registered system claiming dissatisfaction about the FERC's or States' authority to review interaffiliate purchases prior to the court decision in Ohio Power. The registered systems in entering these contracts had to expect both FERC and State regulatory review. Grandfathering of past transactions is a reasonable approach but given the broad nature of contracts in question, grandfathering of existing contracts would defeat the very purpose of the legislation.

Conclusion

I want to thank the Chairman and members of the Subcommittee for the opportunity to comment on this very important issue. The NARUC looks forward to working with all interested parties in the weeks ahead to develop legislation that serves the interests of the Nation's consumers of electricity.

ATTACHMENT #1

**Resolution Supporting Legislation to Clarify Jurisdiction of Federal and State Commissions Concerning Regulation of Investor-Owned Electric Utilities Serving Retail Ratepayers**

**WHEREAS**, In 1935, Congress jointly enacted the Federal Power Act and the Public Utility Holding Company Act (PUHCA) of 1935, which establish Federal authority to regulate the wholesale rates and services and corporate activities of, inter alia, investor-owned electric utilities; and

**WHEREAS**, Last year, Congress enacted the Energy Policy Act of 1992 (P.L. 102-486), which permits wholesale power generators to become exempt from PUHCA through review by the Federal Energy Regulatory Commission (FERC) of their wholesale power sales; and

**WHEREAS**, Title VII of P.L. 102-486 contains provisions that allow investor-owned utilities to own and operate retail electric utilities outside the United States, subject to the review of State regulatory commissions in the case of non-registered utilities and subject to review of the Securities and Exchange Commission (SEC) in the case of registered utility systems; and

**WHEREAS**, The amendments made to the PUHCA by the Energy Policy Act failed to address several issues of importance to State regulatory commissions, including, but not limited to, the following:

(1) codification of the right of State public utility commissions to review the reasonableness of wholesale purchases by electric utilities that serve retail ratepayers;

(2) providing jurisdiction to State regulatory commissions over intrastate wholesale power transactions by electric utilities serving retail ratepayers;

(3) authorizing State commissions to engage in regional integrated resource planning for registered holding company utility systems; and

(4) clarifying and rationalizing the roles that the SEC, FERC and State commissions will assume in regulating the terms and conditions of wholesale contracts entered into by electric utilities that serve retail ratepayers as well as diversification of economic activity by utilities; now, therefore, be it

**RESOLVED**, That the Executive Committee of the National Association of Regulatory Utility Commissioners (NARUC), convened at its Winter Meeting in Washington, D.C., is supportive of efforts in the Congress and in the Administration to examine thoroughly the issues listed above and where necessary enact legislation or redirect resources subsequent to such an inquiry.

---

Sponsored by the Committee on Electricity
Adopted March 3, 1993
Reported NARUC Bulletin, No. 10-1993, pp. 13-14

ATTACHMENT #2

# National Association of Regulatory Utility Commissioners

Incorporated



1102 Interstate Commerce Commission Building
Constitution Avenue and Twelfth Street, N.W.
Washington, D.C. 20423

Mailing Address: Post Office Box 684
Washington, D.C. 20044-0684

Telephone: 202-898-2200
Facsimile: 202-898-2213



**MEMORANDUM**

To: File

From: Chuck Gray, NARUC Assistant General Counsel CG/Gray

Date: February 22, 1994

Re: State Regulation of Transactions between Affiliates of Registered Holding Company Systems

---

Introduction:

The Court of Appeals' decision in Ohio Power Co. v. FERC, 954 F.2d 779 (D.C.Cir. 1992) directly affects regulation of interaffiliate transactions by the FERC (and by extension, the State utility commissions), and accordingly, legislation is necessary to restore the pre-Ohio Power status quo. State regulatory commissions have traditionally and routinely regulated the passthrough of the costs of transactions between utility subsidiaries of registered holding companies and their associate companies. I have found the following decisions of State commissions exercising jurisdiction over a utility subsidiary's acquisition of goods and services (other than power supplies) from an affiliate during the 1970-90 time frame -- clear evidence that prior to the Ohio Power decision, State regulation of non-power interaffiliate transactions was unquestioned.

Discussion:

The earliest case I found is the Ohio Public Utility Commission's 1973 decision concerning the retail ratemaking treatment of Ohio Power's acquisition of coal from an affiliated supplier, Central Ohio Coal Company. Re Ohio Power Co., 3 PUR 4th 52 (1973). In this case, Ohio Power, a utility subsidiary of the American Electric Power System (AEP), applied to the State commission for permission to include the value of the land from which the coal was produced in Ohio Power's rate base, i.e. the invested capital on which the utility earns its return

(profit). The Ohio commission rejected the utility's request to ratebase these investments on the ground that it was inappropriate for the utility to retain title to these properties. Instead, the commission directed the utility to "include as an expense the price of coal consumed directly for the benefit of the consumers in the involved service area." Id. at 55-56. By so doing, the cost of the coal would be based upon a buy/sell transaction between Ohio Power and Central Ohio, and be passed through in retail rates as an expense with no markup.

This case is instructive on a number of fronts:

- First, by directing that Ohio Power expense the cost of coal obtained from Central Ohio (as opposed to the utility retaining title in the coal fields), the Ohio commission created the type of fact pattern that the D.C. Circuit would later review in its 1992 Ohio Power decision. I would submit that had there been any chance that its ruling would raise questions concerning its authority to review the passthrough of these coal costs, the Ohio Commission would not have ruled as it did, particularly when a decision directing Ohio Power to retain title and ratebase these properties (as the utility requested) would have removed any such jurisdictional questions. However, neither the company nor the State commission questioned the commission's authority, regardless of whether the coal costs were ratebased or expensed.

- The second reason this case is important concerns the following statement in the Ohio commission's decision: "It should be noted that several other Ohio electric utilities have entered into arrangements with subsidiary or other related coal companies on the premise of securing a firm supply of coal. None have retained title to the coal lands involved." Id. at 56. This is clear evidence that expensing of the cost of coal acquired from affiliates and State regulation of the passthrough of these costs in retail rates was not unique to Ohio Power, but rather, a standard practice at the time.[1]

- Finally, in its decision, the Ohio commission described findings by its staff that "the price paid for coal is above market price, a situation which may permit [Ohio Power] to profit on its coal arrangement." Id. at 55. Of course, under the D.C. Circuit's Ohio Power holding, references to market price for affiliate purchases would be irrelevant since "cost serves as a ceiling and a floor." 954 F.2d at 785. However, in 1973, neither the Ohio commissioners, their staff, nor Ohio Power had any reason to question the authority of the commission to consider market price as part of its responsibility to protect retail consumers from excessive affiliated coal costs.

---

[1] State commission regulation of coal acquired from affiliated suppliers is not unique to registered holding company systems. I have attached hereto a list of some reported cases involving State regulation of affiliate transactions with coal cases noted. In those cases in which the utility is not a subsidiary of a registered system, there is no legal question concerning either FERC or State jurisdiction to regulate the passthrough of the costs in rates.

The next case I found also involves an AEP affiliate -- Indiana and Michigan Electric Company (I&M) -- regulated by the Indiana Public Service Commission. Re Indiana and Michigan Electric Company, 40 PUR 4th 537 (1981). In a standard ratemaking decision, the Indiana commission reviewed I&M's acquisition of low-sulfur western coal from Blackhawk Coal Company -- a wholly owned subsidiary of the utility. The coal at issue was produced from fields originally owned by I&M and transferred to Blackhawk in exchange for debt and equity securities. The SEC approved the transfer in September 1980, and authorized the recovery of Blackhawk's coal costs, presumably under section 13 of PUHCA. Id. at 548.

In its decision, the Indiana commission rejected a claim from the public (consumer) advocate that since the coal fields were originally owned by I&M, recovery in retail rates of the costs of the utility's purchases from Blackhawk would result in "double counting."[2] Although it considered making downward adjustments to the utility's coal costs as proposed by the public advocate (Id. at 550-551), the commission concluded that the pricing policies established by the SEC's order approving the transfer were appropriate, finding, for example, that the SEC's authorization of the affiliate transaction "barely reflect[ed] the actual capital costs associated with the mining activity." Id. at 549.

Despite its acceptance of the SEC's pricing policies, there was no suggestion in the order that SEC's authorization in any way affected the State commission's authority to adopt any or all of the recommended adjustments to I&M's coal cost recovery. Indeed, rather than question the State commission's authority to deviate from the SEC's authorization, the utility provided a witness to rebut the requested adjustments on the merits. Id. at 548-549. Importantly, it is clear from its opinion that the Indiana commission gave detailed and careful consideration to the arguments of both sides, and resolved the issue independently of the SEC guidelines.

Here too there are noteworthy indications that these kinds of transactions and State regulation of holding company affiliate costs were routine. For example, the Indiana commission took "administrative notice that [I&M's] fuel procurement proceedings are not new to this commission" citing a series of then-recent cases establishing base rates and reviewing fuel adjustment clauses. Id. at 549. Moreover, in describing the circumstances of I&M's transfer of coal properties to Blackhawk, the State commission noted that "[t]he consideration received for the assets transferred followed the guidelines established by the SEC in a large number of

---

[2] The public witness alleged that the utility's ratepayers had already paid for the coal reserves when they were originally acquired by I&M, and accordingly, they should not be charged for the cost of coal purchased from Blackhawk after the transfer. The Indiana commission found that since the originally acquisition had not been included in the utility's ratebase, "[i]t was [I&M's] investors, rather than ratepayers who provided the $191.6 million of [I&M's] investment in those reserves." 40 PUR 4th at 549. Therefore, the commission found that inclusion of the coal costs in retail rates would not result in double recovery.

similar transactions approved by that regulatory body under the Holding Company Act for both the AEP System and several other holding company systems as well." Id.[3]

There is evidence that the West Virginia Public Service Commission also routinely regulated affiliate coal costs of the AEP system pursuant to policies that are remarkably similar to the FERC decision under review in Ohio Power. In Re Appalachian Power Co., Case No. 82-009-E-GI (March 31, 1982) (summarized in the 1983 PUR Annual Digest at 147 (1984)), the State commission adjusted a proposed fuel increment "to reflect the commission's policy of pricing coal purchased from affiliates either at cost or at the level of nonaffiliated coal cost on a total company basis, whichever is lower." Earlier in Re Appalachian Power Co., Case No. 80-314-E-GI (September 30, 1980) (summarized in the 1981 PUR Annual Digest at 154 (1982)), the West Virginia commission "reaffirmed its use of the total company method in repricing affiliated coal, making sure that affiliated coal was not repriced to a level that exceeded its actual purchase price." While the texts of these decisions are not reported, the digest summaries provide substantial support for concluding that State regulation of affiliated transactions was a routine element of the pre-Ohio Power landscape.[4]

Conclusion:

These cases provide direct evidence that prior to the Ohio Power decision in 1992, both State commissions and registered holding companies and their affiliates expressed no doubt that State regulation of the passthrough of the costs of affiliate transactions in retail rates was unaffected by SEC actions or inactions. Of course, the FERC had reached the same conclusion concerning wholesale rates. Accordingly, legislation which (1) restores the authority of the FERC taken by Ohio Power, and (2) protects the authority of the States from preemption in the future would simply recreate the regulatory status quo that existed from the passage of PUHCA in 1935 until 1992.

From NARUC's perspective, failure to include protection for the States in the legislation would pose a serious problem. Such an omission could well be construed to mean that Congress' decision to restore only FERC's authority for wholesale rate purposes confirms an intention to leave State retail rate authority subject to preemption. Given that the great bulk of affiliate costs are recovered in retail rates, failure to explicitly protect State jurisdiction would threaten the interests of consumers in every State served by a registered holding company system.

---

[3] The Indiana commission's description of the SEC's policies as "guidelines" supports the conclusion that the State commissions did not view the SEC orders on affiliate coal issues as establishing binding rules constricting their independent assessment of the reasonableness of an operating utility's costs of retail service.

[4] In addition to the cited cases, there is a great deal of anecdotal information concerning the pre-Ohio Power status quo. Attached hereto is a fax of the December 6, 1979 letter to David M. Neubauer from James L. Akers, Jr., Branch Chief of the SEC's Division of Corporate Regulation which supports the view that SEC and State regulatory jurisdiction did not conflict. Further, prior to the Ohio Power decision, the passthrough of affiliated fuel costs to retail ratepayers via automatic adjustment clauses was sufficiently routine that issues rarely arose for formal adjudication in a reported State commission order. In such cases, State regulation would involve periodic audits of the transactions, resulting in possible adjustments to the cost recovery mechanism.

## STATE REGULATION OF AFFILIATE TRANSACTIONS

1. *+Re Ohio Power Co., 3 PUR 4th 52 (1973).
2. Re Block Island Power Co., 21 PUR 4th 107 (1977).
3. Central Louisiana Electric Co. v. Louisiana PSC, 373 So.2D 123 (1979).
4. *Re Montana-Dakota Utilities Co., 278 NW2d 189 (1979).
5. Re Texas Electric Service Co., 30 PUR 4th 174 (1979).
6. *Re Houston Light and Power Co., 36 PUR 4th 94 (1980).
7. *+Re Indiana and Michigan Electric Co., 40 PUR 4th 537 (1980).
8. *Re Iowa Public Service Co., 46 PUR 4th 339 (1982) and 48 PUR 4th 323 (1982).
9. *Montana-Dakota Utilities Co. v. Bollinger, 44 PUR 4th 318, 632 P.2d 1086 (1981).
10. *Re Montana-Dakota Utilities Co., 44 PUR 4th 249 (1981).
11. *Re Black Hills Power & Light Co., 46 PUR 4th 391 (1982).
12. *Re Public Service of New Mexico, 50 PUR 4th 416 (1982).
13. *Re Houston Light and Power Co., 50 PUR 4th 157 (1982).
14. *Re Pacific P&L, 54 PUR 4th 129 (1983).
15. *Re Washington Water Power Co., 58 PUR 4th 126 (1984).
16. *Re Montana Power Co., 61 PUR 4th 177 (1984).
17. *Washington Utilities and Transportation Comm'm v. Pacific P&L, 68 PUR 4th 396 (1985).
18. Re Iowa Public Service Co., 94 PUR 4th 239 (1988).
19. Montana-Dakota Utilities v. Montana DPSR, 92 PUR 4th 548, 752 P.2d 155 (1988).
20. +Re Indiana-Michigan Power Co., 116 PUR 4th 1 (1990).
21. *Re Florida Power Co., 109 PUR 4th 187 (1990).
22. Re Louisville Gas and Electric Co., 115 PUR 4th 429 (1990).
23. Re Kentucky Utilities Co., 113 PUR 4th 87 (1990).

* Affiliated coal cases.
\+ Utility subsidiary of registered holding company.

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
CORPORATE REGULATION

December 6, 1979

David M. Neubauer
Associate Consumers' Counsel
Office of the Consumers' Counsel
137 East State Street
Columbus, Ohio 43215

Dear Mr. Neubauer:

In your letter of September 5, 1979 and subsequent correspondence you inquired as to whether the legislation concerning electric utility fuel cost adjustment clause pending before the Ohio General Assembly would be in conflict with relevant sections of the Public Utility Holding Company Act of 1935 ("Act") and any applicable regulations or releases pursuant to that Act.

As we understand the intent of the proposed Bill, a captive fuel supply price charged by an electric utility shall not exceed 10% above the average cost of similar quality coal purchased from all independent like mining operations under similar term contracts during the same period. While the text of the Bill does not specifically provide for the creation of a special reserve account for the amount that a captive fuel price exceeds the 10% limit or the ability of the electric utility to earn a rate of return on the deferred amounts in the special reserve account, we understand this to be the Public Utilities Commission of Ohio's concept.

The Act confers jurisdiction over the operations within the State of Ohio of coal mining subsidiaries of Ohio Power Company. As long as the impact of the legislation falls on the operating utility and not the coal mining subsidiary, the statutory and regulatory mechanism as proposed by the Ohio General Assembly would not conflict with our regulations under the Act.

We would like to add a note of caution. It has been our experience that to compare the cost of affiliated and non-affiliated mined coal is very difficult due to different quality, geographical locations, regularity of supply and time periods. We have not been able to derive any realistic methods in this regard.

For your information we have enclosed a copy of the Southern Ohio Coal Company order of April 24, 1978 and a staff publication of registered public utility holding company systems as of December 31, 1978.

If you have any further questions please feel free to contact me or Mr. Robert P. Wason of my staff.

Sincerely,

James L. Akers, Jr.
Branch Chief

Mr. SHARP. Thank you very much. Mr. Patrizia. Despite the previous anecdote, we welcome you here above ground or below ground, whichever depth you wish to present.

Members of Congress at the moment are held—appear to be held in the general community in rather low esteem and the jokes about Members of Congress mirror those about lawyers. As you can appreciate, the Members of Congress who are lawyers have a special category unto themselves, but we are delighted to have you with us.

## STATEMENT OF CHARLES A. PATRIZIA

Mr. PATRIZIA. Thank you, Mr. Chairman. I want to acknowledge Chair Glazer's recognition, and I want to do this on behalf of all the lawyers in the room, not just myself, that lawyers deep down are good people and I would probably be willing to make the same acknowledgment about Members of Congress.

As for those members who are both lawyers and Members of Congress, I was reading, not sure of spelling Dante's Inferno the other day and I don't recall that there was a special place reserved in hell for them.

I am appearing today on behalf of an ad hoc group of registered holding companies which, taken together, generate over 400 billion kilowatt hours of electricity annually. We appreciate this opportunity to express our views about the Ohio Power line of cases and appropriate regulatory jurisdiction over affiliate transactions.

I thank the Chair for including my testimony in the record of this hearing.

I also note, Mr. Chairman, that for several years we have worked with the subcommittee on issues related to the electric utility industry and in 1992, that culminated a 4-year effort to reform the entire structure of the electric generation sector. The repercussions of those changes are still working their way through our industry, and in considering any issues related to the industry's regulatory structure, it is important that the committee recognize the changes already under way and how dramatically they will alter this industry.

As the committee considers the issues before it, we strongly endorse Commissioner Roberts' suggestion that the entire Public Utility Holding Company Act be reviewed and the changes in the regulatory structure be addressed in a coherent and comprehensive fashion and not be done piecemeal.

The regulatory structure within which the registered companies operate is already both time consuming and more burdensome than that faced by other utilities and independent power providers. We have adjusted to the SEC's comprehensive regulation of our business, and while we recognize that our industry will continue to be subject to regulation, no one has made a compelling case that overruling Ohio Power or the duplicative regulation of affiliate transactions will be an improvement.

Electric utility operations are essential in our information and communications driven economy and any changes to the regulatory structure must take reliability as an essential element to be preserved.

Mr. Chairman, at its core, the court's decision in Ohio Power simply recognized the regulatory structure that was envisioned by Congress when it enacted the 1935 act. When the SEC approves an affiliate transaction, FERC and everyone else is bound to that decision and companies may make investments and perform the services and otherwise implement the terms and conditions of the transaction in reliance on the SEC approval.

The Supreme Court, in addressing the circumstances in the Ohio Power case, first found that section 318 of the Holding Company Act simply did not address the particular jurisdictional conflict before it. While all counsel, except Justice Scalia's law clerks may have been surprised by the justices parsing of section 318, nonetheless, the Court's holding was quite clearly that section 318 does not govern the aspects that were before the court.

The Court then expressly remanded the matter to the D.C. Circuit for consideration of the trapped cost issues, giving back to the D.C. Circuit two questions: Whether or not the Federal Energy Regulatory Commission's own regulations were sufficient to require the Federal Energy Regulatory Commission to accept the SEC's jurisdiction, and in any event, whether it would be unfair or unreasonable for a company not to be able to rely on the prior jurisdictional decision of the Agency that regulated that industry.

On remand, the circuit court held that FERC had violated its own rule, that where a prior agency approves a price for fuel in a transaction, that cost is deemed just and reasonable.

The Circuit Court also held that section 13(b) of PUHCA authorized the SEC to impose a cost standard in setting the price for coal and as such, FERC could not use the Federal Power Act's just and reasonable standard to alter that price.

While the FERC market comparability test is, as Dr. Draper has said, symmetrical for all utilities not affiliated with registered companies, application of the standard to the registered companies would place their transactions in a regulatory never, never land. It would create for our affiliate transactions Dr. Doolittle's famous push me-pull you, which is a regulatory animal that I am not prepared to recommend to anyone.

It certainly seems to me that Congress should not create or recognize a regulatory standard so inherently unfair and unreasonable. The subcommittee's invitation asked whether we would oppose restoration of FERC's authority over registered system affiliate transactions. I respond that the Court's ruling seems to indicate that there was no authority to restore, and certainly no one has made a compelling argument as to why duplicative authority would be beneficial from either a regulatory or industry perspective.

However, if any legislation is enacted to change the Ohio Power result, the legislation should make clear that there is only one Federal agency with jurisdiction over the standard for such transactions and adequate procedures for preapproval should be adopted.

I would also note that there has been some discussion this morning of the regularity of hearings. The Federal Energy Regulatory Commission's own statistics indicate that more than 80 percent of the matters which are filed with that Commission are disposed of

without hearing. And the Federal Energy Regulatory Commission also has an ongoing program to try to do as much as they can through paper hearings rather than through hearings before administrative law judges.

So the notion that there is some magic about having administrative law judges having hearings strikes me as a fallacious argument, and in any event, as Commissioner Roberts has already indicated, the Securities and Exchange Commission has Administrative Law Judges and has procedures for hearings where they believe them to be necessary.

Mr. Chairman, you also asked that I address the concept of trapped costs, both in the context of Mississippi Power and Light and Ohio Power. Trapped costs to us refers to situations that occur when an initial reviewing agency approves a cost standard or particular costs and a different agency in a subsequent decision sets rates which do not include the costs approved by the preceding agency. The ability of regulatory bodies to trap costs has been specifically rejected by the Supreme Court. Orders which disallow legitimate costs require the regulated utility to, "pretend that it is paying less for the power it receives than is, in fact, the case."

Duplicative jurisdiction over registered companies risks trapped costs and leaves the registered companies with no means to recover those costs. The Ohio Power decision merely affirms those Federal principles enunciated by the court but in the context of conflicting Federal agency decisions rather than conflicting Federal-State agency decisions.

While trapped costs arose in two different contexts in the Mississippi Power case and the Ohio Power case, they are similar in that both situations resulted in the companies and their shareholders being denied recovery of costs that were previously approved by an agency with appropriate jurisdiction. The Supreme Court has made it clear that that situation cannot stand.

Mr. Chairman, you also asked that I address the situation whereby Pacific Power and Light purchases fuel from its affiliate and you noted that reasonableness of such purchases were fully reviewed by FERC and State Commissions.

As you noted in your question, however, Pacific Power is a multistate company, but not a registered company under the 1935 act. Consequently, unlike Ohio Power and other subsidiaries of registered companies, it is not required to seek SEC approval to enter into affiliate transactions and is not subject to the SEC cost standard.

In PP&L's, case there is no conflict between two Federal agency standards. And I would respond to Chair Glazer's comments that the registered companies are advantaged by noting that the difficulty that the registered companies face which no other companies do, either in the competitive markets generally in this country or in the utility situation specifically.

There is a requirement that we obtain SEC approval before entering into the contract before creating the subsidiary and before making any changes to those contracts. The result is that unlike any other utility company, or indeed any other market participant in the more general markets who can adapt as quickly or as nimbly

as possible to changing market circumstances, the registered companies may not alter contracts without SEC approval.

Finally, I want to emphasize the harm that occurs with duplicative jurisdiction. Ohio Power is good law that should not be overturned. We believe that Commissioner Roberts has proposed and properly proposed a comprehensive review of the 1935 act, and we stand ready to work with the Commission and this committee in that regard.

We also would be pleased to work with the Congress, the Agency and any others who want to improve all aspects of SEC regulation. But improvements in that process should not require discarding 59 years of regulatory certainty for investor, companies and consumers. We certainly will oppose proposed modifications that predetermine the outcome in a way that will trap costs.

I thank you for this opportunity to appear. And I would be very happy to answer any questions.

Thank you.

[Testimony resumes on p. 124.]

[The prepared statement of Mr. Patrizia follows:]

TESTIMONY OF CHARLES A. PATRIZIA, ON BEHALF OF AN
AD HOC GROUP OF REGISTERED ELECTRIC UTILITY
HOLDING COMPANIES

Mr. Chairman and Members of the Subcommittee. My name is Charles A. Patrizia, and I am a partner in the law firm of Paul, Hastings, Janofsky & Walker. I am appearing today on behalf of an ad hoc group of registered holding companies[1] which together generate over 400 billion kilowatt-hours of electricity annually. We appreciate this opportunity to express our views on the issues related to the Ohio Power line of cases[2] and appropriate regulatory jurisdiction over affiliate transactions. I address in the body of my testimony the particular issues raised by the Subcommittee in its letter of invitation.

I note, Mr. Chairman, that for several years we worked with the Staff of the Subcommittee on issues related to the electric utility industry, and in 1992 culminated a four-year effort to reform the entire structure of the electric generation sector. The repercussions of those changes are still working their way through the industry. In considering any issues related to the industry's regulatory structure, it is important that the Committee recognize that the changes working their way through

---

1/ The members of the ad hoc group currently include Allegheny Power System, American Electric Power, Central & South West, General Public Utilities, New England Electric Service, Northeast Utilities and The Southern Company.

2/ Ohio Power Co. v. FERC, 880 F.2d 1400 (D.C. Cir. 1989), rev'd sub. nom, Arcadia v. Ohio Power Co., 498 U.S. 73 (1990), order on remand sub. nom, Ohio Power Co. v. FERC, 954 F.2d 779 (D.C. Cir. 1992), cert. denied, 113 S.Ct. 483 (1992) ("Ohio Power").

the industry will dramatically alter it and that any further changes will also affect the entire registered company system.

Critics of the Ohio Power decision raise the question of effective protection for consumers of registered holding company systems and effective scrutiny of affiliate transactions. To address these reported concerns, some have suggested adding duplicative layers of regulation, or permitting some regulatory agencies to ignore or overrule binding determinations of others. Our position is that allowing an agency to "trap" costs is fundamentally unjust and unreasonable.[3/] That is, it is fundamentally unjust and unreasonable to allow an agency to conduct an after-the-fact review and disallow costs relating to investment decisions worth hundreds of millions of dollars (approximately $300 million in Ohio Power's case) that were made in reliance on the cost standard previously approved by another agency (i.e., the SEC). Moreover, we do not believe that duplicative regulation is required to continue the proper protection for consumers and investors mandated in the 1935 Act. Indeed, such a change would be an abandonment of consistent regulatory authority accepted by the Supreme Court and Congress for almost 60 years, and would unfairly permit overruling decisions on which companies relied in expending significant sums of money.

We continue to believe that PUHCA provides ample statutory authority to fully protect the interests of consumers and there have been no abuses or public

---

3/ A trapped cost situation occurs when the initial reviewing agency approves certain costs and another agency in a subsequent decision sets rates which do not include the costs approved by the preceding agency. This would be particularly adverse to registered companies which make initial investments based on SEC approval, if FERC is allowed to deny certain elements of the previously SEC-approved investment years later.

harm under the current regulatory structure. Moreover, any change in the regulatory structure, particularly piecemeal change, would create enormous practical obstacles to the efficient operation of registered holding companies.

The regulatory structure within which the registered companies operate is already both time-consuming and more burdensome than that faced by other utilities and independent power providers. Virtually every significant business decision in a registered company system requires SEC approval. Acquiring SEC approval of anything other than a routine financing, especially acquiring approval of a new line of business or similar arrangement frequently involves substantial delays. While we have adjusted to the SEC's comprehensive regulation of our business, SEC approval and the time it takes to obtain them, preclude our implementing new strategies quickly. That is a handicap, and it is an increasingly worrisome one as our industry grows more competitive. We recognize that our industry will be subject to regulation, but no one has made a compelling case that duplicative regulation of affiliate transactions will be an improvement.

Thus, any proposal to alter the current regulatory system should not be adopted unless its benefits can be clearly demonstrated, and unless it can be shown to place no risk on continued operations of the efficient generation, transmission and distribution systems which exist today.

## II. THE OHIO POWER DECISION

Mr. Chairman, Mr. Draper in his testimony has developed the factual circumstances underlying Ohio Power Company's decisions which led to the court

decisions which this Subcommittee is reviewing in this hearing. I want to comment on several developments and legal holdings arising from the Ohio Power litigation.[4]

At its core, Ohio Power simply recognized the regulatory structure that had existed prior to FERC's Ohio Power decision and which was envisioned by Congress when it enacted PUHCA in 1935. When the SEC approves an affiliate transaction based on cost,[5] FERC is bound to that decision. That is, the current structure of PUHCA, coupled with section 318 of the Federal Power Act[6] and FERC regulations,[7] permits the SEC to approve contracts with affiliates and enables registered companies to rely upon that approval as explicit acknowledgement of the contract's validity. Once SEC approval is obtained, companies may make the investments and perform the services and otherwise implement all the terms and conditions of the contracts.

An examination of the history of Ohio Power's coal purchases illustrates the concerns over being caught between two conflicting standards. As a result of the SEC approvals beginning in 1971 based on the affiliate arrangement being clearly shown to be advantageous to consumers, Ohio Power invested $57

---

4/ The D.C. Circuit overruled FERC's decision in the Ohio Power case twice. Its first decision was based on section 318 of the Federal Power Act ("FPA") which provides that for certain circumstances, where a person is subject to the conflicting jurisdiction of PUHCA and the FPA, PUHCA controls unless the SEC has exempted that person from the PUHCA requirements. The second decision is more fully developed in this testimony.

5/ Note that the SEC by regulation permits certain affiliate arrangements to be based on a comparable market standard. See 17 C.F.R. § 250.92. However, in Ohio Power's situation, the SEC insisted on applying the "at cost" standard.

6/ 16 U.S.C. § 825q.

7/ 18 C.F.R. § 35.14(a)(7).

million in one mine alone and a total of $299 million throughout southern Ohio in order to ensure the availability of compliance coal for its operating units. All of these investment decisions, and the development of the mines, processing and transportation facilities were made long before any "problems" with the Ohio Power contracts were raised at FERC.

However, intervening between Ohio Power's initial investments and the SEC's initial approvals of those investments was FERC's decision in 1981 that it would evaluate fuel costs based on a "comparable market" test.[8/] The Administrative Law Judge ("ALJ") in his initial decision on Ohio Power's rate application found that the comparable market rather than a cost standard should be applied and FERC affirmed that finding.[9/] Under the comparable market test, while the ALJ found the price for the coal to be reasonable, FERC found the price to be unreasonable.[10/]

The D.C. Circuit decision in 1992 on remand from the Supreme Court overruled FERC's decision that the coal costs were unreasonable on two separate and binding grounds. The court held that FERC violated its own rule that where a prior agency approves a price for fuel in a transaction between affiliates, that cost is

---

8/ See Public Service of New Mexico, 17 FERC ¶ 61,123 (1981).

9/ 25 FERC ¶ 63,060 (Dec. 14, 1983), aff'd in part and rev'd in part, 39 FERC ¶ 61,098 (Apr. 30, 1987). It is ironic that at the same time it applied the market standard to Ohio Power's coal purchases, FERC implicitly upheld the Administrative Law Judge's finding that the costs had been prudently incurred. FERC affirmed the ALJ's opinion, except for the points it specifically rejected. Because FERC did not address the prudency of Ohio Power's investment in the mine, it implicitly affirmed the ALJ's finding that Ohio Power's coal mine and related costs were prudent. Thus, FERC's decision disallowed recovery of costs that it implicitly recognized to be prudent.

10/ 39 FERC at 61,275.

"deemed to be reasonable and includable in the adjustment clause."[11/] Since the SEC had already approved Ohio Power's fuel costs, FERC was bound to defer to the SEC's decision.[12/]

The court further held that section 13(b) of PUHCA authorized the SEC to impose a cost standard in setting the price for the coal being sold to Ohio Power, and as such, FERC could not use the Federal Power Act's ("FPA") "just and reasonable" standard to alter that price[13/]:

> [W]e hold that FERC may not set a cost-trapping rate level where that effect is occasioned by a recovery calculation inconsistent with an SEC determination governing an inter-associate transfer subject to § 13(b) of the PUHCA.[14/]

Thus, to the extent there is overlapping jurisdiction between the SEC and FERC over issues governed under PUHCA's "at cost" standard, the SEC's determination is conclusive.

---

11/ 18 C.F.R. § 35.14(a)(7) (emphasis added). Note that FERC has proposed to revise its rules so that the affiliate costs in question shall be "presumed, subject to rebuttal" to be reasonable, rather than conclusively "deemed" to be reasonable. See 58 Fed. Reg. 51,259 (Oct. 1, 1993). However, such a revised standard -- if applied to registered systems -- conflicts squarely with the D.C. Circuit's holding on trapped costs, and FERC is statutorily barred from altering the SEC's approved price pursuant to FERC's "just and reasonable" ratemaking authority under the Federal Power Act.

12/ 954 F.2d at 784.

13/ 954 F.2d at 785.

14/ 954 F.2d at 786.

## III. SEC Regulation under PUHCA

In 1935, the Congress believed that the SEC had the necessary expertise to oversee financial and securities matters and placed PUHCA under its control. Virtually all aspects of holding company operations involve financial transactions with affiliate companies, transactions which frequently involve the issuance of securities, securitization of debt and the establishment of new corporate relationships. These are precisely the circumstances in Ohio Power where Ohio Power sought to secure a reliable source of coal through the creation and capitalization of an affiliate, Southern Ohio Coal Company. As Mr. Draper testified today, establishing these arrangements through an affiliate was a reasoned, prudent business decision that was necessary to ensure a reliable supply of power to AEP customers.

The focus on corporate structures and financial matters is even more true today in light of the 1992 Energy Policy Act, which has created momentum for significant changes in the electrical generation and transmission sector. Despite the exemptions from PUHCA granted to Exempt Wholesale Generators ("EWG"), however, PUHCA, as amended, remains focussed on the financial relationships between registered holding companies and their affiliates, even as to the establishment of EWG's and foreign utility company ("FUCO") facilities.

PUHCA contains significant authority for the SEC to protect consumers. One of the primary rationales for PUHCA was to prevent the exploitation of the relationships between holding companies and their subsidiaries because of the "absence of arm's length bargaining or from restraint from free and independent

competition."[15] Precisely to address the risk of abuse, Section 13 of PUHCA[16] prohibits various transactions among or between registered company affiliates except with specific SEC approval. Furthermore, the SEC is directly charged with the oversight of such contracts "*as necessary or appropriate in the public interest or for the protection of investors or consumers and to insure that such contracts are performed economically and efficiently for the benefit of such associate companies at cost, fairly and equitably allocated among such companies.*"[17]

The SEC reviews and approves in advance, various affiliate transactions, and the terms and conditions of the arrangements. The required SEC analysis is extensive. The transaction must (1) protect consumers; (2) be performed economically and efficiently; and (3) be at cost, unless specifically exempted by the SEC by order or regulation.[18] Under the statute, the SEC expressly retains continuing jurisdiction over these contracts and can, at any time, determine that a contract no longer meets these statutory requirements. Again, no one has demonstrated that a different regulatory structure or FERC oversight would improve this system.

---

15/ 15 U.S.C. § 79a(b)(2).

16/ 15 U.S.C. § 79m(b).

17/ Id. (emphasis added).

18/ Section 13(b) of PUHCA specifically imposes an "at cost" standard, whereas other provisions of PUHCA and the FPA give the SEC and FERC broad powers to regulate according to a more general "public interest" standard. See, e.g., 15 U.S.C. § 79e and 16 U.S.C. § 824b. Even the definition of "just and reasonable" which FERC applies is left to the discretion of the agency. See 16 U.S.C. §§ 824d, 824e; see also FPC v. Hope Natural Gas Co., 320 U.S. 591, 602 (1944).

Some complain that the registered system companies should be subject to FERC's "comparable market" test. Assuring a fair opportunity to earn a regulated return, or freeing the companies to compete fully at market for goods, is essential to maintain investor confidence in the registered companies. Indeed, it would not be rational for any business to make an investment without some possibility of return. The regulated return under PUHCA limits a registered company's ability to obtain greater earnings when the market would otherwise permit it, while assuring investors that their downside risk is also limited. This was the critical balance struck by Congress in 1935.

Others argue that the SEC is not adequately performing its statutory responsibilities. The SEC, by statute and in practice, reviews all aspects of the contract. Whenever a registered system company requests approval of an affiliate contract, the SEC publishes a notice, and interested parties, including representatives on behalf of retail rate regulators and consumers, are invited to comment as part of the review process. Because the arrangements are pre-approved and there are no cost or operating data, a formal proceeding before an Administrative Law Judge is both unnecessary and unlikely to produce "facts" capable of adjudication. However, it must be emphasized that the SEC maintains jurisdiction over the arrangement and may review the arrangement in the future upon its own motion or upon the request of an interested party.

Perhaps the most important "practical" concern regarding a changed regulatory structure is whether it would be prospective or retrospective in nature. Ohio Power is a case in point. Ohio Power originally sought SEC approval for a captive coal affiliate in 1971. Ohio Power received SEC approval in late 1971 and

began the project. Subsequent to that initial approval, Ohio Power sought, and received, SEC approval for contract modifications on at least three separate occasions through 1982. This is a relatively normal sequence of events for matters before the SEC, which again retains continuing jurisdiction over affiliate relationships.

Giving retroactive effect to any changes in the regulatory structure or standards would place approved contracts and explicit investor understandings at risk, with little or no discernible enhancement to the goals of PUHCA. Modified arrangements, critical to adjusting affiliate relationships to new circumstances while maintaining consumer protection, would be subject to variant standards where no decision was ever final.

As I noted in the beginning of my testimony, SEC regulation is both extensive and comprehensive. We have learned to adjust to the delays in obtaining SEC approvals which are required for virtually every significant business decision we make. However, these delays do place us at a competitive disadvantage compared with electric systems that are not registered systems, and thus not subject to SEC jurisdiction.

## IV. Policy Implications of Ohio Power

### A. Conflicting Cost Standards

Registered companies have been operating in reliance on the SEC "at cost" standard since 1935. This standard limits affiliates to a fair and equitable

allocation of expenses (including the price paid for goods), plus reasonable compensation for necessary capital.[19/]

The cost standard is generally mandated by PUHCA unless the SEC provides an exemption. The registered companies have been able to meet the needs of their integrated service territories under this cost standard, while remaining financially stable. Historically, the SEC standard was recognized by FERC as appropriate, and the operating companies of registered companies were allowed to pass SEC-approved costs through to their wholesale ratepayers.[20/]

FERC, however in 1981, changed its own historic application of a cost test, to a "comparable market" test for affiliate transactions.[21/] Under this standard, FERC will disallow affiliate costs if they exceed the costs paid to comparable, unaffiliated suppliers.

Imposition of the FERC standard on registered company transactions that had been approved under the SEC's "at cost" standard would place affiliate transactions in a regulatory "Twilight Zone", where investments in cost saving affiliate transactions would not occur, to the ultimate detriment of consumers. PUHCA generally bars the registered companies from recovering more than their "cost" even when market prices and market returns are higher. The FERC standard,

---

19/ See 17 C.F.R. § 250.91.

20/ The Supreme Court, by virtue of the remand to the U.S. Court of Appeals and its subsequent denial of certiorari of the Appeals Court's decision on remand has supported the SEC standard. See Arcadia v. Ohio Power Co., 111 S. Ct. 415 (1990), order on remand sub. nom., Ohio Power Co. v. FERC, 954 F.2d 779 (D.C. Cir. 1992), cert. denied, 113 S. Ct. 483 (1992).

21/ See Public Service of New Mexico, supra.

when applied to other utilities, permits affiliate contract prices both to rise and fall to market levels, thus assuring a balance of risk and reward. Some critics, however, through legislation introduced in the other body last year, have sought to put registered companies under an obligation to use the lower of cost or market, preventing any return and creating an unbalance of risk and reward because no higher return can be earned to cover the possibility of lower returns if, or when, market rates fall. In the Ohio Power case, while FERC asserted that Ohio Power could have purchased the coal from "non-captive" sources at prices far below the prices paid to the affiliate companies, FERC also acknowledged that the "market price" had, during some periods, exceeded the affiliate contract price.[22/] This is a classic "heads I win, tails you lose" situation, and it leads inevitably to "trapped costs" which can never be recovered by the companies -- a result which is contrary to most traditional concepts of utility regulation, and which furthers no discernible policy goals.

Imposition of market tests generally assumes there will always be a "market" to measure affiliate contracts against. With coal and similar commodities, this is clearly possible, since fuel is a commodity, where one can easily obtain the latest "market" prices and construct a rough comparison to the affiliate transaction (although differences in sulfur, ash content, volatility and transportation costs would have to be accounted for).[23/]

---

22/ 954 F.2d at 784.

23/ It is difficult to create an exact comparison given the many factors which enter into the decision to purchase goods or services from an affiliate. For example, an affiliate arrangement may offer certain non-economic advantages in terms of operations, personnel, and long term stability of supply which enhance the value of the transaction but which cannot be duplicated in the marketplace.

However, registered companies engage in a wide variety of transactions and services with affiliates for which there is no "comparable market," and which other utilities do internally to the utility company, without creating an official affiliate operation. These affiliate arrangements are encouraged by PUHCA in order to obtain for consumers the inherent advantages they offer in terms of efficiency and cost savings. For example, the registered companies have established service companies which provide, among others, engineering, accounting, legal and personnel services to the entire system. The other companies provide plant operation or scheduling services essential to integrated operations. Centralized accounting or finance operations result in far greater efficiency throughout the system than if each operating company provided its own services. These services are integral to the operation of an integrated holding company system.

Without a readily ascertainable "comparable market" there is a distinct possibility that regulators will err in estimating what rates are "just and reasonable." This uncertainty can have no other effect than disruption of our planning and operations.

In sum, the concern is not so much whether an "at cost" or "market" standard is the preferential standard to apply, although, for the reasons discussed above, the SEC cost standard appears more appropriate for registered systems. The more salient concern is that companies should not be caught between <u>conflicting</u> standards imposed by <u>different</u> federal agencies.

Thus, Mr. Chairman, in response to your question as to whether we would oppose "restoration" of FERC's authority over registered system's affiliate transactions, for the reasons discussed above, the courts have determined that the SEC

has paramount authority in this area for these systems. Moreover, from a policy perspective, no one has made a compelling argument as to why such a structure would be beneficial from either a regulatory or industry perspective. However, if any change in law is made to change the Ohio Power result, then such change should make clear that there is only one federal agency with jurisdiction over the cost standard for such transactions, and adequate procedures for pre-approval should be adopted.

**B. "Trapped Costs" and Preemption: Mississippi Power & Light**

Mr. Chairman, you asked that I address the concept of "trapped costs" both in the context of the Mississippi Power & Light and the Ohio Power decisions. As I explained above, "trapped costs" refers to situations that occur when an initial reviewing agency approves a certain cost standard or costs, and a different agency in a subsequent decision sets rates which do not include the costs approved by the preceding agency on whose decision the company relied in its investment decisions. The ability of regulatory bodies to "trap costs" has been specifically rejected by the Supreme Court which stated that orders which disallow legitimate costs require the regulated utility to "pretend that it is paying less for the power it receives ... than is in fact the case."[24/] This is the essential point of the Court's opinion in Miss. Power & Light v. Miss. ex rel. Moore.[25/] Duplicative jurisdiction over registered

24/ Nantahala Power & Light v. Thornburgh, 476 U.S. 953, 971 (1986).

25/ 487 U.S. 354 (1988).

companies leads precisely to the ability to trap legitimate costs and leave registered companies with no means to recover these costs.

In Miss. Power & Light, the issue was whether the Mississippi Public Service Commission ("MPSC") could prevent Mississippi Power & Light ("MP & L") from recovering through retail rates under prudence or other grounds the costs MP & L was mandated to pay under a FERC order.[26/] This is the classic "trapped cost" scenario: under the MPSC order, MP & L could not recover the FERC mandated costs; that is, once a federal agency approves recovery of costs, action is taken in reliance on that decision, and a state agency does not allow recovery of the costs in a subsequent decision.

The Supreme Court's decision that the MPSC could not "trap" costs rested on principles of preemption under the Supremacy Clause of the United States Constitution.[27/] These include that determining the reasonableness of wholesale rates rests exclusively with FERC, FERC has exclusive jurisdiction over power allocations that affect wholesale rates as well as the wholesale rates themselves, and "States may not bar regulated utilities from passing through to retail consumers FERC-mandated wholesale rates."[28/] The Court held that those principles compelled the holding that

> the MPSC may not enter an order "trapping" the costs MP & L is mandated to pay under the FERC order allocating Grand Gulf power or undertake a "prudence"

---

26/ 487 U.S. at 372.

27/ U.S. Const. art. VI, § 2.

28/ 487 U.S. at 371-72.

review for the purpose of deciding whether to enter such an order.[29]

The Ohio Power decision merely affirms these fundamental principles enunciated by the Court, but in the context of conflicting federal agency decisions, rather than conflicting federal/state agency decisions. Miss. Power & Light illustrates that a utility must be able to recover its FERC-approved wholesale power costs through retail rates. Ohio Power illustrates that a registered company or its affiliate must be able to recover its SEC-approved investment costs through wholesale rates. A contrary result would not comport with the Supremacy Clause (state-federal agency conflicts) or the Due Process Clause (conflict between federal agencies) or fundamental notions of fairness. Thus, while "trapped costs" arose in two different contexts in Miss. Power & Light and Ohio Power, they are similar in that both situations resulted in the companies and their shareholders being denied recovery of costs that were approved by an agency with appropriate jurisdiction, and the companies relied on such approval in investing hundreds of millions of dollars in costs for investments that would enable the companies to better serve their customers.

### C. Non-Registered Affiliate Transactions: Pacific Power & Light

The registered companies are already more stringently regulated than other utilities, and are barred completely, or barred unless the SEC consents, from activities that other electric utilities undertake routinely. For example, Mr. Chairman, you also asked that I address the situation where Pacific Power & Light

---

29/ Id. at 372.

("PP&L") purchases fuel from an affiliate, and you noted that the reasonableness of such purchases were fully reviewed by FERC and the state commissions.

As you correctly noted in your question, PP&L is a multi-state company, but it is not a registered holding company. Consequently, unlike Ohio Power and the other operating subsidiaries of the registered companies on whose behalf I appear today, it did not have to first seek SEC approval to enter into the affiliate transaction, and it thus was not subject to an SEC-mandated cost standard for such transaction. PP&L, as well as any other electric company that is part of a system exempt from PUHCA regulation, is on notice that FERC would have jurisdiction over the costs that would be flowed through to its wholesale ratepayers. Unlike the situation in Ohio Power, there is no conflict between two different federal agency standards in the Pacific Power & Light context, and there is no reliance on the cost standard required by the SEC simply because the SEC does not enter the picture. Moreover, as to state review of retail affiliate costs, PP&L could still argue that the Supremacy Clause and the Miss. Power & Light and Nantahala Supreme Court decisions prevent the states from disallowing costs in retail rates that would have the effect of disallowing wholesale costs approved by FERC.

**D. Ohio Power Does No Damage to the Ideals Expressed in PUHCA**

The procedural history of Ohio Power reveals no affiliate abuse and instead shows proper SEC review and decisionmaking. The contract was initially approved in 1971, and coal production began in 1978. As noted above, FERC did not change its cost standard until 1981, ten years after the SEC's approval of the affiliate transaction. Despite the litigation at FERC and in the courts, and in the face

of the SEC's explicit continuing jurisdiction over these contracts, no "interested" party has yet has asked the SEC to revise the contract terms, although the SEC has audited the costs incurred, and an SEC proceeding is pending at the request of certain Ohio Power customers.

Mr. Chairman, Ohio Power began this process of acquiring captive suppliers in 1918, and has throughout its operating history reviewed as necessary the need for assured coal supplies. Ohio Power is the nation's largest user of coal and thus it could not afford any threat to its supplies of coal. Coupled with this were major price and supply fluctuations occurring at that time, as well as the newly-enacted Clean Air Act requirements. Ohio Power sought to establish these mines to solve many of its concerns: certain supply of compliance coal at a price which was, at that time, reflective of the true costs of production (as recognized by the SEC).

In reliance on the SEC's approval, Ohio Power spent hundreds of millions of dollars to develop this resource. Reversing the Ohio Power decision is an example of 20/20 hindsight which can almost always find fault with past decisions. But, beyond the legal arguments and practical concerns we have discussed, there is a simple issue of fairness and reasonableness which must be evident in all legislative actions.

## V. Legislative History of Transfer Proposals

For the reasons discussed above, we believe that there are no compelling reasons for shifting PUHCA authority from the SEC to FERC. Indeed, it is important to understand that the question of jurisdictional authority under PUHCA is not novel. In fact, every time it has been addressed, the considered

Congressional response has been that the SEC is the proper regulatory agency for primary authority under PUHCA. The placement of PUHCA in the SEC was a deliberate action by the Congress, and Congress has several times reaffirmed that role, during 59 years of growth and stability in the electric utility industry.

This idea was first discussed during the original consideration of PUHCA in 1935 when some in Congress wanted to place PUHCA jurisdiction with the Federal Power Commission (FERC's predecessor agency).[30/] However, Congress enacted PUHCA and gave the SEC full regulatory authority over the holding companies' affiliate transactions.[31/]

Since that time, Congress has considered the transfer of PUHCA to FERC (or its predecessors) on several occasions. For example in 1969,[32/] 1972[33/] and 1973,[34/] the SEC itself proposed transferring PUHCA jurisdiction to the FPC.

---

30/ For example, Congressman James W. Wadsworth of New York offered an amendment to give PUHCA authority to the Federal Power Commission ("FPC"). Congressman Wadsworth raised the concern that "duplication" could result from the FPC and the SEC sharing regulatory responsibilities. 79 Cong. Rec. H10,446.

31/ Congressman Wadsworth withdrew his amendment stating that the provision of the bill which settled conflicts between regulatory agencies (section 318 of the Federal Power Act) would allow sufficient protection against duplication and overlapping authority. Id. at H10,507.

32/ Letter from SEC Commissioner Hugh F. Owens to the President of the Senate and the Speaker of the House of Representatives (December 2, 1969), reprinted in 116 Cong. Rec. H 4045-4046. (daily ed. Feb. 19, 1970).

33/ Letter from SEC Chairman William J. Casey reprinted in 118 Cong. Rec. H 26,275. (daily ed. July 19, 1972).

34/ Letter from SEC Chairman Casey to the Congress reprinted in 119 Cong. Rec. H 11,524 (1973).

In 1975, the FPC prepared transfer legislation which was never submitted to the Congress.[35/] The SEC had by that time reversed its prior position, and opposed transfer in 1975 and testified to that effect in the Congress.[36/] There was neither any compelling policy reason nor a groundswell of support for such a proposed transfer, and each of these transfer attempts failed.

SEC jurisdiction over PUHCA also survived the major restructuring of the utility industry which occurred during and after consideration of the Public Utilities Regulatory Policies Act of 1978 and other proposals between 1975 and 1981. In 1977, President Carter proposed that PUHCA be transferred to the Department of Energy in the interest of organization and bureaucratic efficiency.[37/] However these arguments were again rejected by Congress, and PUHCA remained with the SEC. In commenting on the proposal, Chairman Dingell stated:

> One must ask: Why it is necessary to move these functions relating to public utilities to a Department of Energy . . . one must ask whether it, in fact, is desirable in light of the great questions which relate to monopoly and things of that sort.[38/]

---

35/ ALI Fed. Sec. Code, Reporter's Introductory Memorandum xxviii (Tent. Draft No. 4, 1975) at 491.

36/ *See* Depts. of State, Justice and Commerce, The Judiciary, and Related Agencies Appropriations for 1976: Hearings Before a Subcomm. of the House Comm. on Appropriations, 94th Cong., 1st Sess. 1106 (1975) (statement of SEC Chairman Garratt).

37/ *See* Message from President Jimmy Carter to the Congress (Mar. 1, 1977) (accompanying the proposed Department of Energy establishment legislation) *reprinted in* H. Rep. No. 346, 95th Cong., 1st Sess. 1 app. at 69 (1977).

38/ *Department of Energy Org. Act: Hearings on H.R. 4263 Before a Subcomm. of the House Committee on Government Operations*, 95th Cong., 1st Sess. 170 (1977).

In 1977, following consideration of the Carter proposals, Congress created DOE and FERC, and transferred some regulatory authority to FERC from other federal agencies.[39/] However, Congress specifically rejected arguments that FERC jurisdiction over PUHCA would produce efficiency in energy regulation, and PUHCA authority remained with the SEC.

In the intervening 17 years, since 1977, Congress has considered numerous energy bills and enacted several, most recently the Energy Policy Act of 1992 ("Energy Act").[40/] The Energy Act represents one of the most sweeping changes in the regulatory structure of this industry since 1935; yet Congress left PUHCA in place with primary authority in the SEC.[41/]

Thus, it is clear that Congress initially determined the SEC to be the appropriate agency to regulate PUHCA, and this determination has remained valid for 6 decades. Congress based this determination on one principal factor: affiliate relationships involve financial transactions in all respects, and the SEC is the federal agency with the most experience and greatest ability to regulate such transactions.

## VI. Conclusion

Finally, I want to emphasize that the main point to be gleaned from the Ohio Power decision is the harm that occurs from duplicative jurisdiction. For that

---

39/ For example, oil pipeline regulation was transferred from the Interstate Commerce Commission to FERC.

40/ Pub. L. No. 102-486, 106 Stat. 2776.

41/ Indeed, the Energy Act amended PUHCA by adding new sections 32 and 33 and giving the SEC primary responsibility.

purpose, Ohio Power is good law that should not be overturned. If there is to be an examination of the issues that currently affect registered companies, it should be an examination which reviews the entire context of our regulatory structure, rather than an effort to correct piecemeal individual issues.

However, if the Congress decides that reversing Ohio Power is warranted, we ask that the three principles described in Mr. Draper's testimony be incorporated into any legislation accomplishing this purpose. These principles include that the legislation (1) be prospective only, (2) affect goods only, and (3) provide a mechanism for securing binding FERC approval at the time it makes its initial decision on the affiliate contract.

Congress chose in 1935 to establish the current structure and the registered system companies have lived in the world Congress created. That structure, while it probably should be reexamined in light of current circumstances, should not be reexamined or changed piecemeal. If Congress does make incremental changes, it must recognize that the entire registered holding company system will be affected. Any changes must be done with clarity and must grandfather previously approved transactions.

Mr. SHARP. Thank you very much, Mr. Patrizia.

As you can hear from the bells, the House has about 7 minutes left to vote. So I think probably it would be wiser to take the break and then take Mr. Kanner's testimony. So hopefully in 10 minutes, we will be able to start up again.

[Brief recess.]

Mr. SHARP. The subcommittee will come back to order.

We are pleased to hear now from Mr. Kanner.

## STATEMENT OF MARTY KANNER

Mr. KANNER. Thank you, Mr. Chairman. Rather than summarizing my written testimony, what I would like to do is respond to several of the statements that have been made earlier by Mr. Draper and Mr. Patrizia. We fundamentally and obviously disagree on the purpose of monopoly utility regulation. It appears that they view the purpose as protecting businesses from unrecovered cost and I see the purpose as insuring the reasonableness of electric rates.

Given this polarity of views, it is not surprising that they believe that the post OPCO world is acceptable. It may be acceptable to regulated businesses. After all, as a result of this decision, they are exposed to less regulation than any other type of investor-owned utility transaction. But it is not acceptable to consumers.

As a result of this decision, registered holding companies interaffiliate transactions and only these transactions are immune from just and reasonable rate determinations. The SEC doesn't perform this type of review as they have stated earlier today and FERC and presumably the States are barred from executing this traditional rate responsibility.

FERC has become an automaton passing through all affiliate charges without regard to their reasonableness. The statement has been made that SEC preclusion of FERC review has always been the law and that the Ohio Power decision merely reaffirmed that case. Well, the SEC has stated that they never assumed that their actions precluded FERC review.

As Mr. Robert's statement notices, there are several instances in which they said in their orders that this is not intended to preclude the review by other rate regulatory bodies. So it is sort of surprising to me that the companies have this assumption that this immunization occurred when the regulators themselves did not have that assumption and did not give any reason for others to believe that that assumption was correct.

It is asserted that the SEC review of these transactions is extensive and comprehensive. Judge for yourself. In the case of Ohio Power, the SEC approved the capitalization of affiliate line before the contract was even executed. They had no opportunity to review, nor could there be, the efficiency of the affiliate line or the reasonableness of the projected costs.

There has been no meaningful review of the affiliate's continued performance over time. The SEC lacks the expertise, the resources and the regulatory tools to adequately protect consumers.

This is not a criticism. The SEC never believed it usurped FERC review and therefore never developed independent expertise. Mr. Patrizia has asserted that the court merely affirmed what the Con-

gress also intended, the prevention of duplicate regulation. This summary of congressional intent simply is not true. PUHCA was intended as a backstop for regulation, not as a substitute.

If Congress meant to limit the reach of rate regulators, they could have affirmatively done so. The preamble of PUHCA states that one of its purposes is to facilitate, not frustrate effective rate regulation. As Justices Stevens and Marshall said in their concurring decisions, Congress' intent would be frustrated by a holding that would allow the SEC to hamper FERC's regulation of wholesale rates.

It is argued that this legislation would enable FERC to second guess utility decisions. I am not sure how second guesses could occur when there was not a first guess. The SEC did not do a prudence review, nor did any regulatory body. But the second guessing is not occurring.

They are not looking at the 1971 decision to establish the affiliate. Rather, FERC is reviewing the prudence of the decision to continue to purchase coal from that affiliate line under the same terms and without change. They are asking what steps did Ohio Power take to minimize the excessive costs? Did it reduce affiliate purchases, renegotiate the contract, buy it out, sell the line? In short, did Ohio Power take any of the steps that would occur in a truly arm's length transaction?

Let me put it in layman's terms. Purchasing a house in the late 1970's with a 15 percent mortgage is not inherently imprudent. But not refinancing that mortgage in 1993 is.

Let me demonstrate the point further. The Martinka Mine was sold to Peabody Coal Company who lowered the cost of coal within 5 months from $47 to $29 a ton. Peabody has also said that they will sell the mine, they will shut it down, if they cannot lower the cost further within 2 years.

In contrast, when Ohio Power owned the mine, it invested additional money and expanded operations even as the mine was producing above market coal. In a competitive market, this would be known as trying to make up in volume what you lose on margin.

It was stated that at-cost has always been the SEC standard for affiliate transactions and that lower of cost or market is inherently unfair. In fact, through its implementing regulations from the date of enactment until today, the SEC interpretation of section 13(p) for affiliate provided good has always been lower of cost or market. That is what the SEC's statement says. That is what the plain reading of the rules say.

Thus, as the SEC has testified, its cost standard has always been lower of cost or market, not automatic full cost recovery. And I question if at-cost were synonymous with the guaranteed full cost recovery, then why did the two dozen State disallowances of affiliate costs that Chairman Glazer cited go unchallenged.

Commissioner Roberts has suggested the idea of a NOPR to rereview and establish a standard for affiliate transactions. I would assert is that that standard exists.

Rule 92 states very clearly what should be the standard for affiliate provided goods and services. There is no need for a new standard. Moreover, I believe if there is a legal question as to whether

as the result of Ohio Power, the SEC can in fact now require anything other than full cost recovery.

The court's decision said cost is both a floor and a ceiling. And it is unclear to me that the SEC would be able to effectively utilize the lower of cost or market standard or anything less than full cost recovery.

And lastly, I think a regulatory process is simply an opportunity for delay. It won't solve the basic issue, which is whether or not traditional rate regulators, FERC and the States, can exercise their legally mandated responsibility.

It has also been stated that when FERC considered the New Mexico decision which established the market comparability test, that it must not have considered the impact on the registered holding companies. That assertion is surprising given Chairman Moler's statement in which he cited the 1975 action 6 years before the New Mexico case where they reviewed AEP rates and looked at AEP coal costs and said costs are above market. In a settlement, they disallowed half of what was presumed to be above market costs and put a cap on future affiliate coal supplies.

I also believe that Mr. Patrizia has oversimplified the issue of trapped cost. A trapping does not occur simply because two different agencies use two different standards. For trapping to occur, one agency must mandate an action, thereby denying the company of its free will and another agency must impose a different mandate that assumes that free will exists.

Ohio Power was not mandated to purchase affiliate coal at cost or at any other price. The SEC simply authorized Ohio Power to use its funds to capitalize a subsidiary and then set basic parameters on the subsidiary's actions. The action was on Ohio Power—on the coal mine, not on Ohio Power. And the arrangement was purely voluntarily.

It suggested that future coal deliveries under preexisting arrangements should be grandfathered; placed outside the reach of utility rate regulators. Given the absence of rigorous SEC review of these costs, and the SEC's own statement it didn't presume FERC preclusion, I can think of no other costs that are more deserving of regulatory scrutiny.

And Chairman Moler talked about a very limited grandfathering. In my mind, the appropriate grandfathering is for those prudently incurred costs that have already been recovered in rates. Costs that have not been recovered in rate, costs that have not been determined prudent, should not be grandfathered.

To grandfather all fuel costs would be an extreme measure. For retail consumers, about 30 percent of the price of electricity is fuel costs. To grandfather those is much greater almost than any other action that you could take with respect to affiliate transactions.

Mr. Chairman, the registered holding companies stumbled upon a gold mine and are now engaged in revisionist history in a desperate attempt to hang on. Certainly facts are indisputable. Prior to Ohio Power, FERC and the States could and did conduct just and reasonable rate reviews and could and did disallow affiliate costs. Now they can't.

The SEC never believed its actions preempted subsequent FERC rate review and the SEC never conducted meaningful regulatory

review of these affiliate operations and charges. Now, as a result of this decision, meaningful regulatory review of affiliate charges is effectively precluded and the regulatory gap can be exploited to the extreme detriment of both consumers and competitors.

Thank you very much and I would be happy to answer any questions.

[Testimony resumes on p. 138.]

[The prepared statement of Mr. Kanner follows:]

STATEMENT OF MARTY KANNER, ON BEHALF OF THE COALITION FOR PUHCA

The Coalition FOR PUHCA (Full Oversight and Regulation of Public Utility Holding Companies and Affiliates) is an ad hoc alliance of consumer groups, environmental organizations, large industrial consumers, state utility regulators, and wholesale power purchasers. The Coalition exists for the express purpose of overturning the recent Ohio Power decision and restoring the authority of the Federal Energy Regulatory Commission (FERC) and, as necessary, state utility commissions to regulate the costs resulting from registered holding company inter-affiliate transactions.[1] The Coalition extends deep appreciation to Congressman Boucher for his continued leadership in championing this effort and commends Chairman Sharp for holding this hearing on this critical issue.

The Ohio Power decision (1) eviscerates the traditional authority of federal regulators, and possibly state regulators, to set electric rates, (2) insulates supply contracts between sister companies from full regulatory scrutiny and effective competition, (3) contravenes the congressional intent of the Public Utility Holding Company Act (PUHCA), and (4) exposes retail and wholesale electric ratepayers to abuse. In short, the decision sanctions noncompetitive arrangements even as Congress and the industry are attempting to implement greater competition.

The Coalition urges Congress to promptly enact legislation reversing Ohio Power to ensure that affiliate transactions receive the same regulatory scrutiny as unaffiliated transactions.

## Background

Congress passed PUHCA in 1935 to break up vast utility corporate empires that had abused both investors and consumers. As part of that effort, Congress intended to limit the relationships between utilities and their affiliate companies. These restrictions were prompted by a concern that utility contracts with affiliate companies are likely to:

- result in excessive charges and preferential terms;
- frustrate effective state regulation; and
- restrain free and independent competition.[2]

Ohio Power turns PUHCA on its head: shielding from regulatory scrutiny precisely those charges Congress intended to be subject to the most thorough oversight. By eliminating knowledgeable regulatory review of nonelectric costs, Ohio Power creates a tremendous incentive for the proliferation of uncompetitive registered holding company inter-affiliate supply contracts.

Unless Congress acts to close this regulatory gap, the costs of goods and

[1] Ohio Power Co. v. FERC, 954 F. 2d 779 (D.C. Cir.), cert. denied, 113 S. Ct. 483 (1992).

[2] Public Utility Holding Company Act of 1935, § 2(a)(2).

services provided by affiliates of these registered holding companies will go unchecked by competition or reliable regulatory oversight, electric consumers will be forced to pay excessive rates for uneconomic transactions, and efficient but unaffiliated suppliers of nonelectric goods and services will face high entry barriers. Congress must enact legislation to expose these charges to the same federal and state regulatory review applied to all other utility charges.

## Court Decision Hinders Effective Rate Regulation

As part of a rate case initiated in 1982, FERC reviewed the cost of coal that Ohio Power Company (Ohio Power) -- a utility affiliate of American Electric Power (AEP), a registered holding company -- purchased from a sister coal company. FERC found that the affiliate fuel charges exceeded the cost of comparable, but unaffiliated, coal supplies by as much as 100 percent. These excessive coal costs are passed on directly to wholesale electric consumers. As fuel costs comprise approximately half of the total charge for wholesale electric service, excessive costs can dramatically affect electric prices. To protect the wholesale customers of Ohio Power, the FERC disallowed these excessive costs.

Despite FERC's findings, and after nearly a decade of litigation, a federal appeals court reviewed OPCO's captive coal transactions and ruled that FERC, and implicitly state utility commissions, have no authority to review the reasonableness of the costs of goods and services provided to registered holding company operating utilities by their affiliates, nor the authority to disallow the recovery of any inappropriate costs incurred in such transactions.

The court held that, once the Securities and Exchange Commission (SEC) approves a registered holding company investment in an affiliate supplier, then no subsequent review of any "section 13" transaction (i.e., sale or purchase of nonelectric good or service) between the two entities by FERC is allowed. The SEC's preclusive authority exists even though the SEC does not adequately monitor the administration of these inter-affiliate transactions or the resulting charges. In fact, this preclusion exists even if the SEC <u>never</u> actually reviews the subsequent inter-affiliate transactions. This ruling has created a regulatory black hole: registered holding companies can create (or use existing) sister companies to supply numerous goods and services to their utility affiliates, operate the companies inefficiently and uneconomically, and knowingly charge their wholesale and retail customers excessive rates without facing reliable regulatory or competitive accountability.

## Resulting Regulatory Regime Fails to Protect Consumers

Registered holding company officials have asserted that the Court's decision does not preclude effective regulation; it merely clarifies that regulation of these



84-385 - 94 - 6

inter-affiliate transactions rests solely with the SEC. They claim further that the SEC has monitored and will effectively monitor these transactions. Others suggest that the problem is simply one of staff resources and management guidance, which can be corrected by placing the "right people" at the Commission.

Simply providing better direction to the SEC will not solve the problem. The SEC lacks basic resources and authorities necessary to regulate these complex transactions and protect consumers, including:

- **The expertise to regulate inter-affiliate transactions**: The SEC is a financial regulator. It does not have experience with utility operations, cost-of-service review, ratemaking, or cost allocation. It currently provides only an accounting function, matching bills with invoices. Thus, it could assure that an affiliate charges its sister utility the correct amount for a purchased Mercedes, but does not question whether a car was needed or whether a Chevy would have been sufficient.

- **The regulatory procedures necessary to protect consumers**: The SEC rules do not provide aggrieved parties an express, meaningful procedure to petition the SEC to investigate alleged improprieties between affiliates. Similarly, relevant SEC statutes and regulations provide no explicit mechanism for customers to receive refunds for overcharges paid to utilities for excessive inter-affiliate payments. Without these protections, consumers are denied an opportunity to question the appropriateness of a supplying utilities rates and charges and are forced to pay knowingly excessive electric rates with little opportunity for relief; and

- **the resources to adequately supervise the myriad of complex inter-affiliate transactions**. Only twenty-five SEC staff currently review all PUHCA matters, an insufficient number to review, investigate, and litigate improper inter-affiliate transactions in addition to all of the other issues that come under PUHCA. Only two are accountants. There are no engineers or operations or fuel experts. Our understanding is that there is no SEC staff with expertise to review the efficiency of affiliate operations; yet section 13(b) requires the SEC to ensure that all inter-affiliate contracts are performed "economically and efficiently."

It is no assault on the effectiveness of the SEC to assert that it is ill-equipped to exclusively police these transactions and protect consumers. Over time, the Commission has developed expertise in certain areas. **Since the SEC had no reason to believe that its action under PUHCA precluded subsequent rate review by FERC, it did not develop independent expertise in electric utility rate regulation.** Rather than recreating the necessary expertise at the SEC, Congress should simply restore

the authority of the FERC and state commissions to review these affiliate purchases.

<u>All Utility Supply Contracts Should Be Treated Equally</u>

In passing the Public Utility Holding Company Act, Congress intended to impose on registered holding companies the most comprehensive regulatory regime. Ironically, the Court's <u>Ohio Power</u> ruling provides these select utilities with the laxest regulatory review.

Traditionally, FERC and state commissions operate under broad mandates to ensure just and reasonable wholesale and retail utility rates. Utility commissions must approve rates that neither gouge consumers nor prevent recovery of reasonable and prudent costs. Utility rate regulators perform more than simple auditing functions, or ensuring that consumers are only charged for services actually rendered. Rather, the commissions consider core regulatory issues in utility purchase decisions: (1) whether the utility was reasonable in purchasing a specific product or service, and (2) once a given purchase decision is made, whether the utility purchased the good or service at the best available price. Regulatory review of each cost component -- and particularly major cost components such as fuel -- is necessary to ensure that the overall rate is "just and reasonable."

The comparison of the costs of one utility decision with all available alternatives, commonly known as "integrated resource planning," is one frontier of electric utility regulation. As noted by Arkansas Public Service Commission Chairman Sam Bratton:

> This development has passed the SEC by entirely. The SEC has no staff, knowledge, or experience in this area. Yet under <u>Ohio Power</u>, the SEC has primary and possibly exclusive responsibility for determining whether an interaffilaite transaction is economical and efficient....[S]tate commissions regulating registered holding company subsidiaries cannot conduct enforceable least cost planning if they are preempted from setting rates consistent with their least cost plans.

As a result of <u>Ohio Power</u>, major cost categories are placed beyond the reach of FERC and the state commissions. This fragmentation of the regulatory process

---

In fact, the courts and the SEC have rejected explicitly a role for the SEC in reviewing utility "operations." <u>See</u>, <u>e.g.</u>, <u>City of Lafayette v. SEC</u>, 454 F. 2d 941, 955 (D.C. Cir. 1971).

Prepared Statement of Sam I. Bratton, Jr., Chairman, Arkansas Public Service Commission, before the Senate Energy and Natural Resources Committee, May 25, 1993.

exists only for utilities affiliated with registered holding companies. All other utility supply contracts, even affiliate contracts of exempt holding companies, are reviewable by FERC and the state commissions.

Registered holding company affiliate purchases should receive at least the same level of regulatory scrutiny as other utility contracts.

Treatment of Existing Inter-affiliate Arrangements

Opponents of this legislative effort have raised concerns about the treatment of existing inter-affiliate arrangements, arguing that charges under pre-existing contracts should be immune from FERC and state oversight. The opponents assert that such review unfairly changes the rules after the fact and exposes these charges to competing regulatory standards. Careful review, however, demonstrates that application of this legislation to all inter-affiliate charges -- including those incurred under pre-existing arrangements -- is both fair and necessary:

- **Prior FERC and state review of affiliate charges went unchallenged.** Prior to the Ohio Power decision, state commissions routinely reviewed registered holding company affiliate costs, and disallowed recovery of excessive costs. In at least two instances, the FERC imposed a market comparability test on affiliate fuel purchases and disallowed recovery of affiliate contract costs. In these instances, the authority of state commissions and the FERC went unchallenged.

- **Prior to the Ohio Power decision, the SEC itself did not believe its actions preempted FERC ratemaking authority.**[5] If the implementing agency did not presume preclusion, on what basis can the regulated entities argue that Ohio Power merely reiterated preexisting law? Authorizing FERC and state review of charges under these preexisting arrangement merely restores the regulatory framework under which the SEC initially approved the acquisition of affiliates. Had the SEC anticipated the absence of full rate regulatory review it might have disallowed these affiliate contracts or imposed more rigorous regulatory oversight.

- **No conflict exists between SEC and FERC/State review of these costs.** Congress created distinct agencies with distinct mandates. The job of the SEC is to determine the lawfulness of a contract, the affiliate's charges to the public utility under that contract, and all steps taken in the affiliate's performance under that contract. The role of FERC and the state commissions is to determine whether the recovery from ratepayers of charges incurred by the utility under an affiliate contract is appropriate. Put

[5] Letter from SEC Chairman Levitt to Chairman Sharp and Markey, February 17, 1994, at page 17.

simply, the SEC regulates what the seller can charge the purchaser (e.g. the utility), and FERC and the state commissions determine whether the purchaser can recover the costs from captive ratepayers. Regardless of the rate regulator's determination, the affiliate supplier is repaid in full--either with utility or with ratepayer funds. But if the rate regulators determine that the utility made an imprudent decision, the shareholders must absorb the cost of the error. That is conventional regulatory treatment, with Ohio Power has erased for registered holding companies.

- **All costs inputs that are recovered in rates from electric consumers are expected to be subject to continual regulatory scrutiny.** In a competitive industry, a company faces the risk of losses resulting from a competitor's ability to provide a good or service at lower cost or higher quality. By the same token, regulated monopolies face the risk of regulatory disallowances. In performing their legal mandate, regulatory commissions have disallowed the recovery in rates of investments in generating plants, purchased power contracts, conservation expenditures and other utility investments. Since the SEC does not perform ratemaking review of affiliate charges, the registered holding companies are suggesting -- incorrectly -- that their costs should be exempt from this type of regulatory scrutiny;

- **Existing contract costs should be treated no differently than all other utility contracts.** It is appropriate to shield from regulatory revisitation lawful charges incurred by affiliate suppliers that were recovered by utilities through approved rates. There is no justification, however, for immunizing as-yet-unrecovered past costs, or recovered-but-unreviewed costs from future regulatory review. All other utilities are subject to this type of regulatory scrutiny;

- **Legislation poses no new uncertainty for utilities.** Under PUHCA, the SEC has the authority to rescind or modify any order. Thus, even if a registered holding company affiliate received explicit authority to make charges, the companies knew that the SEC had clear authority to disallow charges in the future (e.g., if the SEC found the affiliate was not performing the contract economically and efficiently). The SEC could even force the company to divest its affiliate holdings if the arrangement became detrimental to the public interest, or the interest of investors or consumers. Thus, allowing FERC and state commission review -- even under a different pricing standard -- imposes no new uncertainty;

- **It is not uncommon for regulated businesses to be subject, over time, to changing regulatory standards.** When, in 1981, FERC switched from a cost-

of-service review to its "market comparability" test for recovery of affiliate contract costs, the new standard was applied to future and existing contracts.

There is no compelling reason to exempt existing contracts from FERC or state review. Allowing FERC and state commission review of unrecovered or unlawful charges incurred under existing contracts would create no greater regulatory uncertainty than previously existed and would treat these contracts no differently than all other utility contracts. Failure to include existing contracts in this legislation will deny consumers essential procedural protections and potentially -- and unnecessarily -- cost consumers millions of dollars.

There is one circumstance in which past costs should be insulated: if the SEC had actually approved a charge, after careful scrutiny, and the cost had been recovered from ratepayers, we believe the traditional rule against retroactivity should bar regulatory revisitation. We are not looking for an opportunity to relitigate matters already fully litigated.

Dual Regulation of Affiliate Contracts Does Not Create "Trapped Costs"

Opponents of this legislative effort, and the appellate court in Ohio Power, have asserted that dual regulation of inter-affiliate costs will result in "trapped costs," costs that cannot be recovered because of conflicting regulatory mandates. The affiliate relationship in Ohio Power and other non-power affiliate transactions is factually distinct from the cases that established the notion of "cost trapping."

In Nantahala[6] and Mississippi,[7] the "trapping" took place because one agency (FERC) ordered a utility to take a certain action; then another agency (a state commission) set the utility's rates as if the utility had been permitted to take, but failed to take, an entirely different action. Put another way, in these two cases the utility had no legal mind of its own in its power purchase decision, yet the state commission treated the utility as having the ability to shop for alternative power:

> [I]t obviously cannot be unreasonable for [Mississippi Power & Light] to procure the particular quantity of high-price Grand Gulf power that FERC has ordered it to pay for.[8]

The facts in Ohio Power, and by extension any other nonpower inter-affiliate transaction, are fundamentally different from those in Nantahala and Mississippi. In Mississippi, the first step toward cost-trapping occurred when FERC ordered the

[6] Nantahala Power & Light v. Thornburg, 476 U.S. 953 (1986).

[7] Mississippi Power & Light v. Mississippi, 487 U.S. 354 (1988).

[8] Id.

utility to buy from its affiliate. No agency ordered Ohio Power to buy coal from its affiliate; here the buyer initiated the plan. Ohio Power sought permission in 1971 to capitalize the coal subsidiary. The entire affiliate transaction was voluntary. No one was required to sell the coal, and no one was required to buy the coal. The "trapped cost" argument does not apply for the simple reason that there is no government-setting "trap." If the coal affiliate's costs are trapped, it is a result of their own inefficient operation.

Moreover, the approval Ohio Power sought was not for the utility to buy coal from its affiliate; the approval was for the affiliate to sell coal to the utility. The SEC did not order Ohio Power to purchase any quantity of coal from its affiliate or buy coal at any particular price. There is no SEC order even approving an Ohio Power purchase, much less ordering a purchase.

The SEC approved a corporate relationship and nothing more. That approval permitted the affiliate to sell coal to Ohio Power (such permission being required by PUHCA section 13(b) ). There was no "trap" created by inconsistent regulatory decisions. Ohio Power's decision to purchase affiliate supplied fuel was Ohio Power's decision alone.

<u>State Authority Must Also Be Affirmed</u>

Some have suggested that, since the <u>Ohio Power</u> case dealt only with FERC review of inter-affiliate charges, that the legislation should also only apply to FERC -- remaining silent on the authority of state utility commissions to review the recovery of affiliate charges from retail consumers. This argument must be rejected, and the legislation must simultaneously affirm the authority of FERC and state commissions:

- The court's rationale for the preclusion of FERC review (i.e., "trapped costs") is equally applicable to state commissions;

- Failure to clarity state authority to review affiliate contract charges could be interpreted as an intentional decision to preclude such review of these transactional costs. At the very least, it will inure litigation on the point;

- Prior to <u>Ohio Power</u>, state commissions routinely reviewed registered holding company affiliate charges. There is no compelling rationale for refusing to restore this regulatory oversight;

- Nearly eighty percent of all electric costs are regulated by state commissions -- not FERC. Failure to include state commissions in any legislative reversal of <u>Ohio Power</u> could leave the vast majority of consumers

unprotected from potentially abusive affiliate contracts.

Legislation Must Cover All Inter-Affiliate Non-power Transactions

The court's decision in Ohio Power dealt with affiliate suppliers of non-power goods and services that are subject to section 13(b) of PUHCA. Some have suggested limiting the legislation to these contracts. The Coalition strongly believes that all inter-affiliate transactions -- including financial transactions under section 12 of PUHCA -- must be covered by the legislation. Otherwise, the Ohio Power court's rationale -- "trapped costs" -- could be applied by a future court to these transactions.

Ohio Power's preclusion rule does not depend on any distinct language of section 13. To eliminate Ohio Power preclusion, any legislative remedy must address all non-power supply SEC-jurisdictional transactions between nonutility affiliates and utility affiliates of registered holding companies.

The SEC has no jurisdiction over inter-affiliate power supply transactions. Of the inter-affiliate non-power supply transactions, section 13 deals only with one subset: service, sales and constructions contracts. Section 12 deals with a distinct subset: loans and financial guarantees.

If Congress overturns the Ohio Power decision with respect to section 13 transactions, but not section 12 transactions, future courts reasonably could infer an intent to make SEC jurisdiction preclusive with respect to section 12 transactions.

Inter-affiliate financing -- like the provision of goods or services -- holds a potential for anti-consumer abuses. For example:

- Assume a utility has excess cash reserves. It loans money to its affiliate at below-market interest rates. Unless the legislation includes section 12, the state commissions and FERC would be precluded from protecting ratepayer interests by insisting on prudent utility behavior by setting rates as if the utility had loaned at market interest rates.

- A nonutility affiliate loans capital to a utility affiliate. Assume that, because the nonutility affiliate has poor credit, its cost of capital is above the market rate. The FERC or a state commission, in setting the rates for the utility affiliate may determine that the utility paid excessive interest charges and seek to limit the company's rate recovery to market interest costs (say the utility's own cost of money from the sale of commercial paper).

To adequately police all inter-affiliate transactions, the legislation must

include both sections 12 and 13.

Legislation Needed to Close Regulatory Gap

The Ohio Power ruling provides registered holding companies an incentive to use affiliates to provide goods and services to sister companies. These noncompetitive arrangements potentially allow these utilities to collect excessive profits from captive wholesale and retail consumers without any threat of reprisal since the arrangements between these affiliates are immune from competition and beyond the reach of federal and state rate and utility regulators. Without competition or regulatory review, there will be no check on excessive pricing and inefficient operation. After all, the basic reason for utility regulation is the lack of competitive market forces faced by natural monopolies.

Failure to act could result in an explosion of affiliate suppliers for a myriad of goods and services. Already the Court's Ohio Power decision has been used to dismiss allegations of "sweeteners" in the sale of an affiliate mine and to argue against FERC review of the allocation of tax benefits between stockholders and ratepayers. Several registered holding companies also have recently formed or purchased new affiliates to provide services ranging from the manufacturing of energy efficient lighting to the decommissioning of nuclear power plants. After Ohio Power, nothing prevents registered holding companies from placing all goods and services in affiliates arrangements -- free from competition and outside the scope of reliable state and federal regulatory review.

Congress must enact legislation to restore FERC's authority under the Federal Power Act to review registered holding company inter-affiliate transactions when setting wholesale electric rates. Similarly, the legislation must clarify the retail ratemaking authority of state commissions with respect to these contracts. All other utility contracts are subject to state and federal regulatory review. Inter-affiliate transactions -- which hold the greatest potential for abuse -- should not be immune from comprehensive regulatory oversight.

Without corrective legislative action, millions of electric consumers, unable to secure regulatory relief, may suffer utility abuse. Providing FERC and the state commissions with clear authority to regulate the costs of goods and services resulting from registered holding company inter-affiliate transactions would:

- impose market discipline on inter-affiliate contracts;
- ensure that affiliate suppliers are selected because they are the most efficient, not the most profitable;
- treat registered holding company supply contracts the same as those for all other utilities; and
- provide electric consumers with protection and relief from excessive charges.

On behalf of the Coalition, I commend Chairman Sharp and Congressman Boucher for bringing this issue to the attention of the subcommittee and urge swift action to enact corrective legislation.

Mr. SHARP. Thank you, Mr. Kanner.

The Chair recognizes the gentleman from Virginia.

Mr. BOUCHER. Thank you, Mr. Chairman.

Mr. Glazer, there seems to be some doubt about whether the Ohio Power decision effectively abrogated the power of State public service commissions to review affiliate transactions. I take it from your testimony that your conclusion in the case of Ohio is that the Ohio Power decision had that effect; is that correct?

Mr. GLAZER. I am not conceding that it had that effect, but those arguments have been made. They have been presented to us by American Electric Power, and I—one thing that I can bet dollars to donuts on is that there will be litigation on that issue and that someone is going to press that point. I am not conceding it at the time being, but certainly there is that argument out there.

Mr. BOUCHER. Given the doubt which has been created with regard to that issue, what is your commission doing today in terms of review of affiliate transactions? Are you proceeding to do it or are you deferring until the matter is settled through litigation or legislation?

Mr. GLAZER. This has been a very difficult issue, and in fact the commission has been embroiled in this subject of affiliate transactions with the AEP affiliate mines for well over a decade now.

Frankly, we have been encouraging some settlements. We just approved a transaction where the company sold the Martinka Mine, as Mr. Draper referred to, but there are other affiliate mines still out there. And more importantly, we are going into a new era as we get into more diversification which this Congress allowed through the amendments of the Energy Policy Act, more diversification in overseas operations, potential diversification into telecommunications. I see a not very rosy road ahead and a very bumpy road ahead unless we resolve this question.

Mr. BOUCHER. I take it that you would like the resolution to be in favor of the State PUC's to construct that level of oversight and regulation.

Mr. GLAZER. Yes. And frankly, that not is a new standard that was the status quo before the Ohio Power decision.

Mr. BOUCHER. Let me ask Mr. Draper and Mr. Patrizia how you would respond to the suggestion which has been made by a number of witnesses here, including Mrs. Moler from the Federal Energy Regulatory Commission, that say the lack of adequate resources and proper mechanisms in order to review affiliate transactions exist today at the SEC, clearly suggesting that there is not proper Federal oversight of these transactions given that lack of adequacy?

How do you respond to that, if in fact you take the position that we should not begin to address this matter legislatively and ensure that at least some agency is conducting appropriate oversight?

Mr. Draper.

Mr. DRAPER. Let me take a shot at it. And I am sure Mr. Patrizia will as well. I am not expert in what resources the SEC has, but it seems to me that it is important to take a look at the results and see if it is plausible that things are going terribly wrong.

It has been pointed out that 49 million households are served by the registered holding companies. And, in fact, I believe that the

evidence will show that the rates of the registered companies is competitive and in most cases below the rates of similarly situated utilities in proximity to those companies. I know that is the circumstance in my case.

Chairman Glazer has talked about the exempt companies and the registered ones in Ohio and our rates are among the lowest. Talk about the issue of the affiliate lines and our buying fuel from them, there again is an end results test. About 20 to 25 percent of the kilowatt hours we sell every year are sold to other utilities, not affiliates of American Electric Power. That electricity is produced by burning the fuel we buy. And if we are able to sell that in the market, which is a very competitive market, it seems to me that our decisions can't be all that bad.

And so it seems to me that while there may be need to change the regulatory framework, at least from a plausibility point of view, the system is working pretty well. And I as a representative of the registereds, I don't feel that I have to hang my head about these interaffiliate transactions. It has worked for the benefit not only of our customers, but for nearby utilities that purchase power from us.

Mr. BOUCHER. Let me ask Mr. Glazer and Mr. Kanner if they agree with the basic proposition that there should not be disparate regulation between the exempts on the one hand and the registered utilities on the other with regard to the costs that are allowable.

Mr. Draper said in his testimony, and I think stated the case well, that there was a circumstance in which that occurred that led to the Ohio Power litigation in the first instance, where because the registereds are subject to SEC jurisdiction, they are entitled to recover their costs and that is the measure of recovery in every case.

And because they also, prior to the Ohio Power decision, were subject to FERC jurisdiction, they were told that fair market value with respect to comparable products was a measure and the net effect of that was that they were restricted in recovery to the lower of costs or the comparable market price of whatever it was they were selling on an interaffiliate basis.

Whereas the exempts, not being subject to SEC jurisdiction, were not restricted in terms of just being able to recover costs. They were allowed to recover the comparable market price of that product, whether it was above or below their costs.

So in effect the registereds have the worst of both worlds. They got the lower of cost or comparable market price whereas the exempts were able to recover fair market price, even though that might exceed their costs. That wouldn't be fair, would it? You would agree to the unfairness of that, wouldn't you?

Mr. GLAZER. I read that in Dr. Draper's testimony and I went back and reviewed what actually is happening and in fact——

Mr. BOUCHER. Before you embark on what is happening, the question really is a pre-Ohio Power question, because what is happening today is very different. Ohio Power did change the circumstance and eliminated that unfairness.

The reason I asked that question with regard to the pre-Ohio Power circumstance is because I am hoping that you agree and Mr. Kanner will agree that whatever changes we make here should not

result in a reinstitution of that kind of regulatory disparity in the future.

Mr. GLAZER. Congressman Boucher, I would agree with you if, in fact, there was a regulatory disparity before Ohio Power. But the facts are different. There really was not a regulatory disparity. For the exempt holding companies, my commission, all 50 State commissions, passed through those costs at cost, at the lower of cost or market. We don't allow an exempt to pass this through at market.

If this pen was $2 on the market, but the utility had its business and generated it for $1, we would pass that through at $1, not at $2 per the exempt holding company.

Mr. BOUCHER. Let me just interrupt you for a second. Even though that might be your practice pre-Ohio Power, the FERC also would have a shot at that registered utility pre-Ohio Power, and if the market price for that product at that point in time was below the cost, FERC would have required that the maximum recovery be the market equivalent which would have been a measure of less than cost.

So if I understand Mr. Draper correctly, even though your commission would allow a higher recovery, FERC would have ratcheted that recovery down.

Mr. GLAZER. I am suggesting that we would not on the exempts. We are talking about the exempts on that side of the equation, we don't allow the higher amount. We allow the lower of cost or market. So I would suggest that pre-Ohio Power, it was the same treatment between the registered and the exempts. And FERC operated on a cost of service basis.

Mr. BOUCHER. I understand your response and I apologize for the interruption. You were referring to the exempts. Mr. Draper wants to respond to that.

Mr. DRAPER. I think the case in point was the one in public services in New Mexico when Jerry Geist, at the time he was chairman, had a fuel affiliate and he wanted to sell fuel from that affiliate to public service of New Mexico at the then-market price and FERC agreed that was OK.

Mr. PATRIZIA. And I would note that that market price was higher than the cost. It was not a lower of cost or market. I also have to disagree with Chair Glazer regarding what happens in all 51 jurisdictions. The rate standards differ jurisdiction to jurisdiction. Many of the States still use a cost-based standard, which is not a lower of cost or market, it is a cost based standard. They may well look at market cost to determine whether or not the costs being incurred by a utility are prudent. That is a different question.

And there has been some confusion about three terms here that I think really need to be defined if we are going to all be talking about these same issues. No one has indicated that Ohio Power challenges the ability of FERC or a State commission to set rates. What Ohio Power does is to say that in setting rates, certain costs must be deemed to be just and reasonable. The actual determination of the rate to be charged for electricity is a determination made by the jurisdictional commission, FERC or the State commissions.

It is also not the case that FERC did a prudence review in the Ohio Power case. In fact, the Administrative Law Judge in the Ohio Power case made the determination that in the long run, ratepayers benefited from that at-cost contract and would continue to do so. There was a difference in the standard to be applied by the Agency. It simply is not the case that the Agency was constructing a prudence review. Mr. Kanner——

Mr. BOUCHER. I am sorry. Let me interrupt you if I may. My time is somewhat limited. I am focusing on a somewhat narrow issue here. We are looking for some guidance as to the principles that we should incorporate in legislation that, call it, "corrects" the Ohio Power decision, if you will, or creates a better framework for regulation in the future.

And what I am trying to do is get some general agreement from Mr. Glazer and Mr. Kanner that, at minimum, we should not create a regime that results in the kind of disparate regulation that I think Mr. Draper has pointed out occurred in at least one case where the FERC allowed that higher return based on comparable price.

You would agree, would you not, that one of our guiding principles ought to be that we not establish a framework in which that could occur.

Mr. GLAZER. Congressman, I agree that whatever the outcome is, that it ought to be fair and similar treatment between the registereds and the exempts and one possible way to do that, as I suggested, is to amend section 13(b) of PUHCA to get out of the situation where SEC is arguably limited to cost. Throw the whole thing back to FERC and the FERC can then treat the registereds and the exempts the same and we are out of this problem. So, in fact, I think my suggestion would accomplish what you are seeking.

Mr. BOUCHER. Mr. Kanner, without great elaboration, can you comment on whether you think it is appropriate that we incorporate that as one of our guiding principles?

Mr. KANNER. Chairman Glazer has stated what States can do. The SEC itself has said lower of cost or market is the appropriate standards and has said there may have been some instances we can argue about whether an exemption to that was granted or not.

But I think the real issue, there is nothing in the—in any of the legislative drafts that I have seen that address the implementation standard that should be used, whether it is market or cost or lower of cost or market. The objective is to restore the authority of FERC and the States to ensure just and reasonable rates.

FERC can decide tomorrow that there is some different pricing mechanism that accomplishes that goal. And they should have the freedom to do so. The fact that on a certain day, they use a market comparability test doesn't mean another day they are going to use the same one. But we do know that their job is to set just and reasonable rates.

And while Mr. Patrizia stated that the decision doesn't block the FERC from doing that, what it does say is you can set just and reasonable rates, you just can't look at half of the cost inputs.

Mr. BOUCHER. OK. As a practical matter, I am confident that the SEC is going to continue to have some role in this regulation. Whatever one may think of the appropriateness of the viability of

PUHCA over the long term, it is going to remain viable over the long term. That is a political reality. And the SEC is going to continue to have a role in regulating the registered holding companies. They will have a role in reviewing interaffiliate transactions.

So I think what we have to do is establish a regime within that reality where we don't create the potential for disparate regulation and exempts on the one hand and registered on the other.

Let me move on to another question. Let me just get you, if you would, Mr. Glazer——

Mr. SHARP. If the gentleman wishes to stay, the Chair has a 1 p.m. appointment.

Mr. BOUCHER. Let me then yield back to the Chair. I have a couple of other questions and I will ask those after the chairman. Thank you very much.

Mr. SHARP. Let me do this. I am not sure that I have any more specific questions. But I wanted to give an opportunity for each panelist to take a minute to comment, which we generally have been doing, on points they would like to make in counter to points that others have made on these issues. I am not sure how necessary this is at this point.

Dr. Draper, if you have anything you want to focus on. Our goal has never been to try to re-examine this case in detail. As an oversight hearing, our concern is to determine if there is a legislative hole that needs to be plugged here.

Mr. DRAPER. I understand. The principal point that I wished to make a moment ago, I believe that registered holding companies are providing good value to the customers of this Nation and as time goes on, and the electric business gets more competitive, the issue for us, whether we are registered, exempt, or not registered in any fashion, will be to provide value to the customers at the lowest possible cost. And I believe that in that sort of regime, this issue of who reviews the various cost inputs will become less important and more important will be the end result.

Mr. SHARP. Mr. Glazer.

Mr. GLAZER. Just briefly, I think we are going to a more competitive environment, and I think the Ohio Power decision is an anomaly in that because it basically says market is irrelevant, and let's look at things at cost. And that is really contrary to where the market is going, where in fact this Congress has said it wants this industry to go.

Although I would like to say this issue is waning, it isn't. I really feel it is going to get more complicated as we move into telecommunications, foreign subsidiaries, et cetera. So there really is a need to resolve this issue.

Mr. SHARP. Mr. Patrizia.

Mr. PATRIZIA. Mr. Chairman, I would simply return to the point Dr. Draper made earlier that if it is true that we are moving to a more competitive environment, and I think that legislation certainly in the last Congress and I think other pieces of legislation that are being proposed and the direction FERC and the States are moving in will all force us in that direction.

It is critically important that the registered companies not be subject to additional burdens or additional duplicative regulations that hinders their ability to be competitive in that market. They

serve a very broad swath of this country and they have to be able to compete on relative terms without having to jump through extra hoops that everybody else doesn't have to go through.

Mr. KANNER. Mr. Chairman, we may or may not be moving, and at what pace is unclear, to a more competitive market. In the interim, there are some municipal utilities that are represented here today that buy power at wholesale from the Ohio Power Company. By their estimations, they will be paying $1.5 million a year in excessive fuel costs as part of those power bills.

To say 10 years from now we may have a fully competitive market means they spend $15 million that they need not spend.

Mr. SHARP. Let me do this: If my colleague wants to have further questions, I will let him chair the hearing.

Then, gentlemen, we appreciate your time and attention to this complex matter, which we will certainly be hashing over perhaps for years to come but at lease the years ahead—I am sorry, no, please.

I misheard my colleague. I thought he said he had no questions and he does have questions, so I will turn the Chair over to the gentleman from Virginia.

Mr. BOUCHER [presiding]. Let me simply do this, Mr. Chairman. We have been here a long time. Let me ask Mr. Glazer and Mr. Kanner if they would respond to this set of inquiries in writing. Respond to the suggestions made by Mr. Draper that in any legislation that we write, we ought to insert a couple of provisions.

One of those on some form of preclearance requirement that would essentially say that in advance of making an investment or entering into a contract, a utility would get the benefit of certainty that it could recover whatever costs or commitment it is making through its rates. And of course, this is again within the purview of interaffiliate transactions. So your response to the appropriateness of that. Be as generous as you can in terms of meeting that.

Second, your response to his suggestion that any legislation apply the new principles and tests particularly as they relate to price of comparable products, only to goods and not to the exchange of services on interaffiliate basis on the theory the services are much more difficult to value and, therefore, subject to less exact regulation.

And then third, your general statements with regard to retroactive application. What could be grandfathered and what should not? And specifically, I heard you Mr. Kanner mention that there may be certain categories of fuel contracts that perhaps could be subject to grandfathering whereas others are not. And I guess that would be based on whether or not the contracts had been subject to some kind of effective oversight at the time they were entered into.

But your comprehensive response and itemization of what should be subject to grandfathering and what should not would be most helpful.

It is going to be a little while before we do anything with this. You have, perhaps, 3 weeks to make those responses. And if you could do that, it would be most helpful to us.

I just want to add my comments to those of the chairman thanking all of you for being here today. Your commentary has been ex-

tremely helpful as we seek to address this challenging set of questions.

Thank you very much.

Mr. GLAZER. Thank you we very much. We appreciate your allowing us to testify and the time that it took today. Thank you.

[Whereupon, at 1 p.m., the subcommittee was adjourned.]

[The following material was received for the record:]

# *Coalition* FOR PUHCA

**Full Oversight and Regulation of Public Utility Holding Companies and Affiliates**

An ad hoc alliance of consumer groups, environmental organizations, state regulators, industrial consumers, and consumer-owned utilities

Mary Konner
Coalition Coordinator

1575 Eye Street, NW
Suite 370
Washington, DC
20005-1175

202/789-0443
fax
202/289-8450

June 7, 1994

The Honorable Rick Boucher
2245 Rayburn House Office Building
Washington, DC 20515

Dear Representative Boucher:

At the May 26 hearing of the House Energy and Power Subcommittee, you asked that I respond to the three "conditions" recommended by American Electric Power CEO E. Linn Draper for any legislation restoring FERC authority to oversee registered holding company inter-affiliate transactions.

While I am encouraged by the fact that Mr. Draper can find some form of corrective legislation acceptable, I cannot agree to his proposed restrictions. As detailed below, the proposals unnecessarily limit the authority of federal and state regulators to review these transactions and would allow the potential for inter-affiliate abuses to continue.

<u>Grandfathering of Existing Arrangements</u>

Mr. Draper recommends the broadest possible grandfathering of inter-affiliate arrangements: freeing from full regulatory scrutiny all existing arrangements, including (1) as-yet-unrecovered past costs and (2) all future costs.

Mr. Draper justifies this proposed grandfathering on the basis that "it is not reasonable or equitable to 'change course' and overturn policies upon which registered companies and their investors relied ...." As noted in my testimony on behalf of the Coalition FOR PUHCA, it is not uncommon for regulated businesses to be subject, over time, to changing regulatory standards. For instance, when FERC switched in 1981 from a cost-of-service review to its "market comparability" test for recovery of affiliate contract costs, the new standard was applied to future and existing affiliate arrangements. Moreover, prior to the Court's ruling in <u>Ohio Power</u>, the companies had no basis on which to assume FERC (or state) preclusion. In fact, as noted in Chairman Moler's testimony, in a 1975 case FERC sought to impose a market comparability test on AEP's affiliate fuel purchases. AEP ultimately settled the case, agreeing to return over $20

million in excess charges and to cap the charges for future captive coal purchases from those mines. There are also numerous instances of state commission disallowances of registered holding company affiliate purchases.

Certainly Mr. Draper realizes that, as a condition of monopoly service, all cost inputs that are being recovered in rates from electric consumers are subject to continual regulatory scrutiny. In fulfilling their legal mandate to ensure "just and reasonable" rates, regulators must have the freedom to review all cost inputs and to impose whatever cost standard may be necessary to ensure just and reasonable rates.

Large capital expenditures are recovered through rates over many years. The costs associated with large capital investments made ten or twenty years ago are still being recovered today. Regulators traditionally determine whether such past costs should continue to be recovered. For instance, state regulators have disallowed the recovery of costs associated with generating plant construction when changed circumstances (e.g. lower than projected load growth) have rendered a portion of the plant no longer economic. In these instances, regulators are assessing whether continuation of past arrangements -- without efforts to discontinue or alter the relationship -- remains prudent today. This is precisely the standard that FERC would be applying to its review of pre-existing affiliate arrangements.

Mr. Draper recommends not only immunizing previously incurred costs, but also present and future investments in these existing facilities. Thus, he is not simply requesting assured cost recovery for existing coal piles, but also for future coal deliveries and even costs associated with expansion of high-cost captive mines.

I would agree to a very limited grandfathering provision that comports with existing regulatory standards. Namely, previously incurred, prudent costs that have already been recovered in past rates should not be subject to regulatory revisitation. All other costs should be reviewable. This is the standard for all other utility costs.

<u>Exclusion of Service Contracts</u>

I find no merit in Mr. Draper's suggestion that service contracts be excluded from FERC and state review

Services include a broad multitude of potential cost inputs. Service affiliates could provide such costly services as nuclear decommissioning, demand-side management, telecommunications, and transmission construction. To ensure just and reasonable rates, state and federal regulators must be able to review all cost inputs.

Mr. Draper appears to justify this exclusion by arguing that "market comparability"

is an inappropriate standard for service contracts. This is a red-herring. FERC's market comparability test currently applies only to affiliate fuel purchases -- not service contracts. Thus, on its face, Mr. Draper's concern is unfounded.

Moreover, it insults the skills of regulators to assert that they are unable to determine how to ensure the reasonableness of various affiliate provided services. The Coalition is not requesting imposition of a particular cost standard. Rather, we are simply asking for a restoration of FERC's authority, and affirmation of states' authority, to determine and set just and reasonable rates based upon a review of all cost inputs. Determination of appropriate standard and review mechanism can be decided by the relevant commissions.

Binding Pre-Approval

Mr. Draper also requests inclusion of an upfront, binding approval that would "ensure that if the registered implements its program in an efficient, prudent manner, it will recover its costs through the rates charged to its customers." Frankly, I am perplexed by this recommendation, since the plain language of the proposal parallels the current regulatory compact in which utilities are allowed to recover prudently incurred costs.

My suspicion is that the registered holding companies are, in fact, seeking predetermination of the prudence of a proposed investment. While utilities have sought such protections in numerous forums, there is no broad application of this approach, and I see no reason to provide such assurance in this context. To the contrary, inter-affiliate arrangements are the least deserving of any predetermination. Given the potential for abuse, there is no compelling reason for regulators to relinquish their ability to determine on an ongoing basis the prudence of a utility in acquiring a good or service through an affiliate and the efficiency of that affiliate's operation. Conceding to this request would render meaningless the purpose of any Ohio Power legislation: providing ongoing regulatory review of affiliate charges for goods and services.

Mr. Draper's recommendation would undermine the precise authority that the legislation would seek to establish: regulators could review the reasonableness of affiliate charges, but they would have to first agree that all affiliate charges will be determined reasonable.

Conclusion

Mr. Draper's recommendations are not fertile ground for compromise discussions. At their heart, these recommendations eviscerate the basic purpose of any Ohio Power legislation -- restoration of FERC authority to review affiliate charges in setting just and reasonable rates.

I hope that this information answers your questions and allows us to move forward expeditiously on corrective legislation. Please feel free to contact me if you have any questions or need additional information.

Sincerely,

Marty Kanner
Coalition Coordinator

# National Association of Regulatory Utility Commissioners

Incorporated

KEITH BISSELL, President
Tennessee Public Service Commission
460 James Robertson Parkway
Nashville, Tennessee 37243-0505

BOB ANDERSON, First Vice President
Montana Public Service Commission
1701 Prospect Avenue
Post Office Box 202601
Helena, Montana 59620-2601

EDWARD H. SALMON, Second Vice President
New Jersey Board of Regulatory Commissioners
44 South Clinton Avenue
CN-350
Trenton, New Jersey 08625-0350

1102 Interstate Commerce Commission Building
Constitution Avenue and Twelfth Street, N.W.
Washington, D.C. 20423

Mailing Address: Post Office Box 684
Washington, D.C. 20044-0684

Telephone: 202-898-2200
Facsimile: 202-898-2213

PAUL RODGERS
Administrative Director
General Counsel

GAILE ARGIRO
Treasurer

June 9, 1994

The Honorable Rick Boucher
2245 Rayburn House Office Building
Washington, D.C. 20515

**Re: NARUC Responses to Questions Posed at May 26th Hearing**

Dear Congressman Boucher:

During the May 26th hearing before the Subcommittee on Energy and Power, you asked me to respond to three questions derived from suggestions contained in the statement by Dr. E. Linn Draper, Jr. of American Electric Power regarding legislation addressing the Ohio Power decision.

On behalf of the National Association of Regulatory Utility Commissioners (NARUC), I respectfully submit the following responses:

**1. Please comment on the suggestion that legislation should grandfather investments already made and arrangements already entered into (Draper Testimony at 7).**

**NARUC Response:** As we have stated in our prepared testimony, grandfathering all existing affiliate contracts and arrangements would defeat the very purpose of legislation addressing the Ohio Power decision. This suggestion implies a very broad exemption that would include all unrecovered past costs and all future costs. Such a proposal is not acceptable for the following reasons.

First, prior investments and arrangements made under contracts with affiliates of registered utility holding companies are "evergreen" in the sense that the exist until some other contractual relationship is agreed upon. Costs incurred under these contracts continue to be in effect for the duration of the contract, which can be for many years into the future. These costs are still being incurred today, and thus should be subject to FERC and State regulatory scrutiny.

Second, these contracts were signed with the knowledge that State commissions as well as FERC would scrutinize the costs associated with them. As the memo attached to our statement shows, there is a substantial body of cases in which State commissions exercised their ability to disallow non-power affiliate costs prior to Ohio Power (see Appendix 2). To allow an exemption for these contracts is to change the standard of regulatory review that has existed for nearly 60 years.

NARUC, however, would not oppose the inclusion of a limited grandfather clause that would not open for relitigation past costs previously determined to be prudent by the FERC and States and already recovered in rates.

As a final matter, any grandfathering of fuel costs would render the point of legislation meaningless. Fuel costs make up approximately 30% of consumers' bills. To blanketly exempt such a large amount of dollars (which the SEC by its own admission has not reviewed for reasonableness) would do harm to the 49 million American households served by registered holding companies.

**2. Please comment on Dr. Draper's request that any legislation cover goods, not services (Draper Testimony at 7).**

**NARUC Response:** Excluding service contracts from Ohio Power legislation would eliminate a whole range of services currently being provided by affiliates of registered utility companies. These services can range from such diverse functions as janitorial to computer programming. This proposal would not only create an unbalanced regulatory approach to affiliate costs by blanketly allowing some costs to escape regulatory scrutiny while covering others, it also would establish an arbitrary distinction between goods and services that would invite mischaracterization by registered systems in order to escape State regulatory review.

The rationale for this proposal is that it would be a difficult, if not impossible, task for regulatory commissions to determine the reasonableness of costs associated with affiliate service contracts. This is simply not the case. State commissions do comparisons all the time to determine the reasonableness of costs being incurred by the utility company. This is a fundamental function of a State regulatory commission in carrying out its mission of ensuring just and reasonable rates for utility customers. More fundamentally, the appropriate regulatory treatment of service contracts is fully with the expertise of FERC and State commissions.

**3. Please comment on Dr. Draper's request that any legislation include a provision for obtaining "binding approval at the threshold, up-front before the investment is made or the arrangement entered into." (Draper Testimony's at 8)**

**NARUC Response:** In some instances, State commissions have adopted preapproval policies, usually in the context of integrated resource planning (IRP). In these situations, State commissions give prior approval to the utility's plans on how it proposes to meet its customer load growth forecast. Approval of utility IRPs does not guarantee recovery of future costs associated with specific utility transactions.

Preapproval in the context of Ohio Power does not make good ratemaking or public policy sense. State commissions must have the ability to determine on continual basis the prudence of costs incurred through an affiliate relationship with the operating utility company. These costs must be scrutinized routinely to prevent potential abuses of these relationships so that situations such as that which arose in the Ohio Power case do not occur i.e. the operating utility paying above market prices for coal purchases from an affiliate coal producer without regulatory review of reasonableness. Without continual scrutiny and the ability to disallow imprudent costs, ratepayers would be at risk of having to pay higher rates. I might add that the system in place prior to Ohio Power was balanced and symmetrical. Utilities are compensated for the risks associated with changed circumstances through State commissions granting them a return on equity which reflects that risk. If we were to go to a mandatory system of "binding preapproval" we would be forced to recognize this virtual elimination of risk (which no competitive firm enjoys) and adjust utilities returns on equity accordingly.

The NARUC greatly appreciates the opportunity to provide you with these responses. We believe that a legislative remedy to the Ohio Power decision is needed and that this must include State commissions, which must have the ability to regulate millions of dollars in interaffiliate transactions of registered utility holding companies that impact the rates paid by some 49 million households in 30 States.

Sincerely yours,

Craig A. Glazer
Chairman
Public Utilities Commission of Ohio

cc: The Honorable Philip R. Sharp
The Honorable Michael Bilirakis
The Honorable Paul E. Gillmor

Office of the
Consumers' Counsel

77 South High Street, 15th Floor
Columbus, Ohio 43266-0550

MEMO FOR THE RECORD
Date Sent: 7/19/94
Hearing Date: 5/26/94
Material Forwarded on: 7/19/94

June 7, 1994

The Honorable Philip R. Sharp
Chairman
House Subcommittee on Energy & Power
331 Ford House Office Bldg.
Washington, D.C. 20515

Dear Mr. Chairman:

Thank you for holding the May 26, 1994 hearing on the Ohio Power issue. The State of Ohio Office of the Consumers' Counsel (OCC) Governing Board, on July 28, 1993, adopted a resolution urging Congress or the courts to authorize the Federal Energy Regulatory Commission (FERC) and state public utility commissions (PUCs) to review and disallow certain inappropriate wholesale and retail costs associated with interaffiliate contracts signed by operating utilities within a public utility holding company system subject to registration under the Public Utility Holding Company Act (PUHCA). A copy of the resolution is attached.

As you are aware, a recent court decision created a regulatory gap which, if not closed will deny utility consumers in Ohio and 29 other states an effective forum to challenge key components of wholesale and retail electric rates.

OCC has long opposed federal preemption of state authority, and the imposition of unreasonable and imprudent costs upon Ohio ratepayers. The enclosed resolution also recognizes our involvement in the Ohio Power case, where in 1992, we restated in an amicus brief before the U.S. Supreme Court the Governing Board's policy that state PUCs should have the authority to establish retail electric rates and disallow imprudent costs.

As a result of the U.S. Supreme Court upholding a lower court decision, a new legal precedent was set. Under this ruling, the SEC is the sole agency to regulate and approve interaffiliate transactions within a registered holding company system. The court specifically preempted the FERC's authority, and by implication may have also precluded state PUCs from being able to disallow costs from retail rates. This takes away a necessary regulatory apparatus that exists elsewhere throughout the electric utility industry in that state PUCs generally have retail ratemaking authority and the FERC has jurisdiction with respect to wholesale ratemaking.

The Public Utility Holding Company Act (PUHCA) requires that a cost based rate be applied by the SEC for interaffiliate transactions, although in fact, the rates should be the lower of cost or market. If the FERC and state PUCs are prevented from doing their jobs by the SEC, then registered holding companies would have every incentive to expand their integrated non-utility affiliate businesses without regard to supplying the least cost products to their utility affiliates.

By closing this regulatory gap through legislation, appropriate regulatory authority would be restored. Registered holding companies would be discouraged from making unwise non utility subsidiary investments unless they could demonstrate that the investment would result in savings for consumers and would thus provide products at a rate which would be the lower of cost or market. I urge the Subcommittee to correct this regulatory gap and thereby provide to consumers this very basic level of protection. I also request that this letter and the attached resolution be incorporated into the May 26 hearing record.

Thank you for your consideration. If you have any questions, please do not hesitate to contact me or Federal Liaison Larry Frimerman at (614) 466-8574.

Sincerely,

Robert S. Tongren

ROBERT S. TONGREN
CONSUMERS' COUNSEL

RST/tj

Enclosure

Bd. R. 93-20

RESOLUTION
OF
THE CONSUMERS' COUNSEL GOVERNING BOARD
STATE OF OHIO

Urging Congress or the Courts to Clarify That the Jurisdiction of the SEC is Not Intended to Preempt State Utility Regulators and the FERC from Disallowing Unreasonable Costs for Ratemaking Purposes

**WHEREAS,** the State of Ohio Office of the Consumers' Counsel (OCC) is on record supporting the authority of state public utility commissions to disallow costs unreasonably or imprudently incurred by utility companies, and of the Federal Energy Regulatory Commission (FERC) to disallow costs found not to be just and reasonable;

**WHEREAS,** the D.C. Circuit Court of Appeals in (Ohio Power v. FERC, 954 F.2d 779 (D.C. Cir. 1992) issued an interpretation of the Public Utility Holding Company Act (PUHCA) that restricts the ability of the FERC, and could be read as restricting the ability of state PUCs to protect consumers from paying excessive costs for transactions among utility affiliates;

**WHEREAS,** the Court ruled that the FERC did not have authority to disallow from Ohio Power's wholesale rates excessive affiliate coal purchase costs since the Securities and Exchange Commission (SEC) had previously approved the transaction under PUHCA;

**WHEREAS,** the Court of Appeals decided that the SEC, not the FERC, is authorized to set the prices charged for transactions between affiliates of a public utility holding company system;

**WHEREAS,** the Court effectively allowed the SEC to intrude into the ratemaking process, even though the SEC has little expertise in ratemaking and generally approves holding company interaffiliate transactions with little review;

**WHEREAS,** the Court decision may allow a utility subsidiary of a holding company to disregard lower cost suppliers and buy from its affiliate, provided the seller's price does not exceed its own cost as defined by the SEC under PUHCA;

**WHEREAS,** ratepayers could be forced to pay unjust and unreasonable rates if a registered holding company's affiliates' unreasonable prices are permitted to be charged to its utility affiliates;

**WHEREAS,** this would create opportunities for holding companies to use corporate structures to escape market accountability for inefficiency as well as opportunities for cross-subsidization;

Bd. R. 93-20
Page Two

WHEREAS, the court's decision threatens millions of ratepayers currently served by the electric public utility holding companies now subject to PUHCA's interaffiliate transaction rules;

WHEREAS, many public utility holding companies have already created special service subsidiaries to undertake functions formerly performed by the utilities themselves, such as power supply planning, legal services, mining, land ownership, accounting, power generation, and emissions allowances handling services;

WHEREAS, these utility affiliates' costs may be passed onto consumers virtually unchecked unless the effect of the Court's decision is reversed; and

WHEREAS, the prices charged to utilities by their affiliates should be the lesser of cost or market;

THEREFORE, BE IT RESOLVED that the State of Ohio Office of the Consumers' Counsel Governing Board (OCC) urges clarification by Congress or the Courts that the jurisdiction of the SEC is not intended to preempt state regulators and the FERC from disallowing unreasonable costs for ratemaking purposes; and

THEREFORE, BE IT FURTHER RESOLVED that OCC urges Congress or the Courts to find that the prices charged to utilities by their affiliates must be the lesser of cost or market-based rates.

Babe Erdos
HAROLD "BABE" ERDOS, CHAIRMAN

Frank Sollars
FRANK SOLLARS, VICE CHAIRMAN

Bob Bash
ROBERT E. BASH

Craig S Cobb
CRAIG S. COBB

James H Harris
JAMES HARRIS

Herman E Kohlman
HERMAN KOHLMAN

LARRY MITCHELL

Clarence Seavers
CLARENCE SEAVERS

Richard J. Solove
RICHARD J. SOLOVE

DATED: July 28, 1993

**Statement**

**of the**

## Ohio Power Company Wholesale Customer Group

**for the**

## House Energy and Power Subcommittee

**Hearing on**

## Ohio Power Legislation

**May 26, 1994**

The OPCO Wholesale Customer Group is comprised of 15 municipal electric utilities that purchase all or nearly all of their power from the Ohio Power Company (OPCO).[1] The OPCO Wholesale Customer Group participated in the FERC and court cases reviewing OPCO's affiliate coal purchases, and will pay excessive power rates as a result of the court's ruling in this matter. We urge Congress to promptly overturn this decision and restore the authority of the Federal Energy Regulatory Commission (FERC) to exercise its responsibilities and ensure that OPCO can recover only "just and reasonable" rates.

Put simply, the court's OPCO decision allows utilities that are part of registered holding company systems to purchase goods and services from affiliates without the controlling forces of either effective regulatory oversight or competitive pressures. Insulated from both regulation and market forces, registered holding company (RHC) affiliates have no motivation to operate economically or efficiently. As a result, electric ratepayers will be forced to pay excessive rates to cover these uneconomic transactions. Congress must act to restore the authority of FERC to review the costs of all goods and services, including those supplied by affiliates, when setting electric rates for utilities that are part of registered holding company systems. Ratepayers of registered holding companies should receive the same regulatory protections available to all other electric consumers.

### Background

The American Electric Power Company (AEP) is a registered utility holding company that owns eight operating electric utility companies, including the Ohio Power Company (OPCO). OPCO in turn owns three coal companies, one of which, Southern Ohio Coal Company (SOCCO), owns several coal mines. SOCCO's Martinka mine (recently sold to an unaffiliated coal company) is the "captive coal mine" that was at

[1] The OPCO Wholesale Customer Group includes the Cities of Bryan, Clyde, St. Clairsville and Wapakoneta, and the Villages of Arcadia, Bloomdale, Carey, Cygnet, Deshler, Greenwich, Ohio City, Plymouth, Republic, Shiloh, and Wharton. The largest of these communities is Wapakoneta, which serves about 5,000 customers; the smallest is Wharton, with less than 200 customers.

issue in the OPCO case.

Because AEP is a registered holding company, the Public Utility Holding Company Act (PUHCA) requires that its investments be approved by the Securities and Exchange Commission (SEC). In 1971, the SEC granted Ohio Power's request to invest $10 million in SOCCO to develop the Martinka Mine. OPCO told the SEC that it would buy all the coal from Martinka at "cost," including a return on investment. In subsequent orders, the SEC approved additional investments by Ohio Power in SOCCO to further develop the Martinka Mine. It is worth noting that the SEC approved the investment, not the terms of the underlying contract. The SEC certainly did not compel OPCO to purchase coal from SOCCO. All of the SEC orders stated that the price at which SOCCO sells coal to OPCO will not exceed the cost to the seller (SOCCO). At issue in the subsequent court case was the question of whether the SEC's action simply set "cost" as a ceiling for the rates that could be charged for the captive coal supplies, or both a ceiling and a floor.

In 1982, Ohio Power filed for a wholesale rate increase at the Federal Energy Regulatory Commission (FERC). During the subsequent rate case, the OPCO Customer Group and FERC staff argued that OPCO had been paying substantially more for its affiliate captive coal than the price of comparable coal that could be competitively acquired from unaffiliated companies.

FERC found that OPCO's captive coal costs were unreasonably high -- exceeding the comparable market price by 28 to 100 percent within a six year period. FERC ordered Ohio Power to refund to the OPCO Wholesale Customer Group the difference between the cost of affiliate coal purchases and the comparable market price for the overcharges paid while the rate case was pending. The FERC further ordered OPCO to prospectively charge the Customer Group only the market price for coal -- regardless of the actual cost of producing coal from its affiliate mines. If SOCCO could cut its costs below the market price, OPCO would receive additional profits. If it failed to beat the price of its competitors, then OPCO would only recover the market price, rather than the total "cost" billed for its affiliate coal.

During the next four and one-half years, Ohio Power fought this ruling in the courts, arguing that FERC had no authority to review the cost of OPCO's affiliate coal purchases. Ohio Power asserted that the SEC's "at cost" requirement assured the company recovery of all costs without consideration of the appropriateness of those costs. FERC and the Wholesale Customer Group argued that other requirements of PUHCA are designed to ensure that "costs" are "economic and efficient" and that, in any event, the action of the SEC did not circumscribe the authority of the FERC to review the reasonableness of all cost components -- including affiliate purchases -- in setting wholesale rates.

On February 4, 1992, the Court of Appeals held that a regulatory overlap between the SEC and FERC existed. To resolve this alleged overlap, the court determined that the "at cost" standard contained in PUHCA was more specific than FERC's "just and reasonable" directive, and, therefore, FERC was barred from reviewing OPCO's captive coal purchases. While the OPCO Customer Group believes the court

grossly erred in its ruling, it is important to recognize what the court did **not** determine. It did **not** conclude that:

- the cost of OPCO's captive coal purchases was reasonable or appropriate;
- the SEC had adequately regulated these captive coal purchases; or
- the resulting regulatory regime will adequately protect consumers.

**Court Ruling Puts Electric Consumers at Risk**

The court's ruling has left the OPCO Customer Group without a forum -- available to almost all other electric consumers -- to question the costs of its wholesale power supplier. The members of the Wholesale Customer Group have been forced to repay OPCO $5 million in excessive charges and will continue to pay wholesale electric rates that include excessive costs for captive coal. Coal costs comprise about 50 percent of the total wholesale power rate of Ohio Power. Continued uneconomic coal purchases from affiliate mines will result in the Customer Group paying $1.5 million per year in excess charges, according to our calculations.

This is not simply an issue for wholesale electric consumers. The logic of the court's determination that the SEC holds preclusive authority with respect to registered holding company inter-affiliate transactions will similarly preclude state commission review of these transactions. For that reason, legislation to overturn the OPCO decision is supported by the Public Utility Commission of Ohio, the Ohio Consumers' Counsel, the Ohio Municipal Electric Association, and the Industrial Energy Users-Ohio. All classes of ratepayers -- wholesale and retail, residential and industrial -- are harmed by OPCO and will benefit from corrective legislation.

**Current SEC Review Inadequate**

The registered holding companies argue that OPCO did not create a regulatory gap, but simply determined that inter-affiliate transactions are regulated exclusively by the SEC. The OPCO Customer Group takes little comfort from the knowledge that the SEC can regulate these transactions. Without significant changes in the SEC's regulatory responsibility, a dramatic increase in resources dedicated to reviewing these transactions, and a major shift in institutional priorities and perspectives, there is little reason to believe that these transactions will be adequately reviewed and that consumers will be adequately protected. This determination is based on the SEC having:

- approved OPCO's initial investment in SOCCO without any review of the underlying contracts (and consequently the economics of the investment);
- approved subsequent investments in OPCO's affiliate mines without any review of the efficiency of then existing operations;
- ignored, since 1989, complaints filed by the OPCO Wholesale Customer

Group alleging excessive captive coal costs; and

- failed to review the terms of sale -- in what we believe to be apparent violation of PUHCA -- when OPCO sold one of its affiliate mines.

This is not to say that the SEC should have no role in reviewing inter-affiliate transactions. But it must be recognized that the SEC has little experience or expertise in cost-of-service regulation. Moreover, PUHCA does not explicitly provide the SEC with the necessary regulatory tools to adequately protect consumers, and the agency does not currently have the staff or resources to fully and effectively oversee these transactions. If the SEC is to continue to exclusively regulate inter-affiliate transactions, the agency needs legislation to provide clearer guidance, necessary regulatory tools, and additional resources.

A better approach is to overturn the OPCO decision and restore FERC's traditional ratemaking authority.

**Affiliate Purchases Should be Exposed to Market Forces**

Registered holding companies object to efforts to allow utility rate regulators to apply a market test to affiliate purchases, asserting that anything less than full cost recovery of its affiliate operations would contravene reasonably held expectations and be financially devastating. A review of the facts shows that full cost recovery was never a reasonably held expectation:

- the SEC rules implementing PUHCA call for affiliate suppliers to charge rates that mirror those of unaffiliated suppliers;

- prior to the court's ruling, holding companies had no reason to believe that the FERC or relevant state commissions could not review affiliate purchases and disallow costs above market. In fact, the Public Utility Commission of Ohio had previously regulated these purchases;

- year after year, OPCO told state regulators, in justifying its affiliate coal supply arrangements, that the affiliate mines eventually would meet or beat the prevailing market cost of coal. Thus, by OPCO's own admission, a market test is an appropriate regulatory standard[2]; and

- OPCO recently agreed, as part of a state settlement with respect to its acid rain compliance plan, to charge retail ratepayers no more than a specific price for its affiliate coal -- even if that price were below the actual cost of production.

Thus, holding companies had no reason to suspect that the recovery of imprudent or excessive costs from affiliate operations were guaranteed.

[2] Despite these pledges, the cost of coal from the Martinka mine never fell below the cost of comparable coal from unaffiliated suppliers.

The suitability of a market test for affiliate purchases is further evidenced by the recent sale of one of the OPCO-owned mines -- the Martinka mine that was the subject of the court case -- to an unaffiliated coal company. Within five months of purchase, the new owner reduced the cost of coal from the mine from $47 per ton to $29 per ton. The new owner also plans to shut down the mine within two years unless costs decrease further. In contrast, when OPCO owned the mine and enjoyed automatic cost recovery, it steadily increased investment in and expanded output from the mine.

The SEC has asserted that "Ohio Power, by requesting orders, effectively sought a variance from Rule 92, which prescribes a lower-of-cost-or-market standard for transfers of seller-produced goods."[3] Despite this assertion, nowhere in (1) OPCO's applications for the four orders, (2) the SEC's notice of those applications, or (3) the orders themselves, is any variance from Rule 92 specifically requested or specifically granted. Rule 92 is not mentioned, cited, or discussed in any of the documents. There is no basis for assuming that Rule 92 -- and the pricing standard contained therein -- did not apply to these affiliate contracts. Unlike other SEC rules, Rule 92 is self-executing and has no provision for exemption. According to the SEC's own rules (Rule 100), an exemption from the SEC's rules must be specifically requested and granted.

**FERC Oversight Must be Restored**

The Federal Power Act vested in FERC the responsibility for reviewing and approving wholesale electric rates. To effectively exercise that responsibility, FERC must be able to review the appropriateness of each cost component that goes into providing electric service. FERC's ability to adequately administer its responsibilities is undermined if certain cost components are placed outside its regulatory reach. This is precisely the result of the court's OPCO ruling. Since OPCO, the FERC has the ability to review all cost components for all electric utilities ***except*** those that are part of a registered holding company system. Utilities that are part of registered holding company systems should be treated in this context like all other utilities.

FERC has the resources, authorities, and expertise to conduct cost-of-service studies and review the appropriateness of these costs. Unlike current SEC rules, wholesale customers and other consumer representatives can call for a FERC investigation of utility purchase practices and can receive refunds if excessive charges are discovered.

Absent strong regulatory oversight, nothing prevents OPCO from continuing to purchase overpriced coal from its affiliates and electric consumers will continue to be saddled with the resulting excessive costs.

This issue deserves prompt congressional action. Legislation should be enacted to provide the FERC and state regulatory commissions with clear authority to review registered holding company inter-affiliate transactions and disallow the recovery of excessive costs. All other utility contracts -- including affiliate contracts of exempt holding companies -- are subject to state and federal regulatory review. Registered holding company inter-affiliate contracts hold the greatest potential for abuse and should not be immune from effective regulation.

[3] SEC Statement to the Senate Energy Committee, May 25, 1993, page 6.